



IN THE COURT OF CHANCERY FOR THE STATE OF DELAWARE

IN AND FOR NEW CASTLE COUNTY

LEONARD T. GANTLER, PATRICIA A. )  
CETRONE, JOHN GERNAT, PATRICIA )  
GERMAT, PAUL MITCHELL and MARSHA )  
MITCHELL, )

Plaintiffs, )

v. )

WILLIAM L. STEPHENS, P. JAMES KRAMER, )  
WILLIAM S. EDDY, DANIEL E. CSONTOS, )  
ROBERT I. SHAKER, LAWRENCE SAFAREK )  
and FIRST NILES FINANCIAL, INC., )  
a Delaware corporation, )

Defendants, )

C.A. No. 2392-VCP

**PLAINTIFFS' ANSWERING BRIEF**  
**IN OPPOSITON TO DEFENDANTS' MOTIONS TO DISMISS**

ROSENTHAL, MONHAIT & GODDESS, P.A.  
Norman M. Monhait (Del. Bar. No. 1040)  
Jessica Zeldin (Del. Bar No. 3558)  
919 North Market Street, Suite 1401  
Wilmington, Delaware 19899-1070  
(302) 656-4433  
Attorneys for Plaintiffs

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## NATURE AND STAGE OF THE PROCEEDINGS

Plaintiffs are shareholders of defendant First Niles Financial, Inc. (“First Niles” or the “Company”); one is also a former director. On September 1, 2006, they filed a three-count, detailed complaint against certain First Niles directors and officers, based, in part, on plaintiff Leonard T. Gantler’s knowledge as a Company director. Plaintiffs alleged that the individual defendants breached their fiduciary duties by acting for their own self-interest in: (i) refusing a value-maximizing firm offer for the Company; and (ii) pursuing a reclassification program (the “Reclassification”) that provides the individual defendants greater liquidity for their First Niles stock at the expense of the unaffiliated shareholders. The complaint further alleged that the individual defendants breached their fiduciary duties by misrepresenting material facts with respect to the reclassification in a preliminary proxy statement filed with the Securities and Exchange Commission (“SEC”). Among other things, the preliminary proxy represented that the “board *unanimously* approved pursuing a stock reclassification rather than a cash-out merger;” to the contrary, plaintiff Gantler clearly opposed the self-interested Reclassification.

Shortly after plaintiffs filed their initial complaint, defendants amended their preliminary proxy, correcting many but not all of the misdisclosures identified in plaintiffs’ initial complaint. After defendants filed a definitive proxy, plaintiffs amended their complaint (the “Complaint” or “Compl.”). Defendants have moved to dismiss the Complaint pursuant to Court of Chancery Rule 12(b)(6), claiming that plaintiffs fail to state a claim for breach of fiduciary duty. Defendants Csontos and Shaker -- both members of the First Niles Board of Directors -- have also raised issues of personal jurisdiction. For the reasons set forth in this Answering Brief in Opposition to Defendants’ Motions to Dismiss, plaintiffs submit that defendants’ arguments are without merit.

## STATEMENT OF FACTS ALLEGED IN THE COMPLAINT

### A. The Parties.

Plaintiffs are all, and have been at all relevant times, First Niles shareholders. Plaintiff Leonard T. Gantler is a former director of the Company, having served in this capacity from April 16, 2003 until April 26, 2006. He is a certified public accountant, licensed in both Ohio and South Carolina, and served as the First Niles Audit Committee financial expert until March 7, 2006. Gantler, together with his wife plaintiff Patricia A. Cetrone, beneficially owns 49,625 First Niles shares, or about 3.6% of the stock outstanding. Plaintiffs collectively own 121,715 First Niles shares. (Compl. ¶ 6).

First Niles is a Delaware corporation headquartered in Niles, Ohio. The Company is a unitary holding company formed as a result of the demutualization of Home Federal Savings and Loan Association of Niles (the "Bank" or "Home Federal"). It has no significant operations outside of those of Home Federal. Home Federal is a single branch, federally chartered stock savings association. Its principal business consists of attracting retail deposits from the general public and investing those funds primarily in permanent and construction loans secured by first mortgages on one- to four-family residences. First Niles stock was traded on the NASDAQ SmallCap Market. (Compl. ¶ 7).

Defendant William L. Stephens is Chairman of Board, President and Chief Executive Officer of both First Niles and the Bank. At the time plaintiffs filed the Complaint, he was 74 years old and had made the Bank his life's work. Stephens served as a director of the Company since its demutualization, and has been employed with the Bank since 1969. He is a participant in the Company's Employee Stock Ownership Plan ("ESOP"), and will receive a distribution of about 32,000 First Niles shares when he retires. (Compl. ¶ 8).

Defendant P. James Kramer is a director of both First Niles and the Bank, positions he has held since 1994. He chairs the First Niles Audit Committee and sits on its Nominating and Compensation Committees. For his service as a director, Kramer received \$13,300 in director's fees in calendar year 2005. He has also been the recipient of both stock awards and options to purchase Company stock. Jointly with his wife, Kramer currently holds 4,781 shares of First Niles Common Stock. The fees and benefits that Kramer receives as a director are material to him as he is a man of modest financial means. Kramer is currently employed in a family-owned business, William Kramer & Sons, a small heating and air conditioning company, operating out of a building in downtown Niles, Ohio that was recently appraised by the Trumbull County auditor for \$88,200, but refinanced with a \$250,000 mortgage. William Kramer & Son's heating and air conditioning business also provides heating and air conditioning services to the Bank. Kramer has discussed becoming a full-time employee of the Bank if the Reclassification is approved. Additionally, Kramer consented to false disclosures in the proxy statement sent to shareholders and filed in connection with the Company's April 20, 2006 annual shareholders meeting. That proxy statement indicated that Stephens was not present during compensation committee deliberations and votes involving Stephens' compensation. Not only was Stephens present during a January 4, 2006 meeting at which a vote was taken to increase Stephens' compensation, but Stephens also participated in the vote. (Compl. ¶ 9).

Defendant William S. Eddy is a director of both the Company and the Bank, positions he has held since 2002. He is a doctor of osteopathic medicine, practicing in Niles, Ohio. He has no formal business training, and voted with defendant Stephens on every issue put before the Board during plaintiff Gantler's tenure as a director. Eddy has continuously demonstrated unquestioning allegiance to defendants Stephens and Kramer. He has refused on

numerous occasions to investigate the circumstances regarding stock options Kramer exercised in apparent violation of the 1999 Stock Option and Incentive Plan (the "1999 Option Plan") (see infra, at pp. 5-6). Additionally, Eddy consented to the same false disclosures discussed above regarding Stephens' compensation in the proxy statement filed in connection with the Company's April 20, 2006 annual shareholders meeting. Eddy owns 1,149 First Niles shares jointly with his wife. (Compl. ¶ 10).

Defendant Daniel E. Csontos is a director of both the Company and the Bank, positions he has held since April 20, 2006. He has been a full-time employee and officer of both First Niles and the Bank at all relevant times; that employment provides his livelihood. Csontos has served both institutions as compliance officer since 1996 and as corporate secretary since 2003. Csontos' total beneficial ownership of First Niles stock is 12,456 shares, all of which are held by the Company ESOP. (Compl. ¶ 11).

Defendant Lawrence Safarek is Treasurer and Vice President of both the Company and the Bank, full-time employment positions that he has held at all times relevant hereto; that employment provides his livelihood. Safarek supports the Reclassification and is deemed by the Company to be a "filing person" for purposes of the Proxy. He is also a participant in the First Niles ESOP, which holds about 26,000 of his 89,962 First Niles shares. (Compl. ¶ 12).

Defendant Robert I. Shaker, a Niles native, has been a director of First Niles and Home Federal since January 4, 2006, when he filled a vacancy created by the death of former director, Ralph A. Zuzolo. He is a lawyer with Shaker & Shaker LLP of Niles, Ohio. Shaker specializes in defense of driving under the influence charges and other criminal matters. Shaker is a member of First Niles Audit, Compensation and Nominating Committees. According to the

Company's proxy statement filed in connection with the 2006 annual shareholders meeting, he does not meet the Audit Committee financial literacy requirements. He owns 17,708 shares of First Niles common stock. (Compl. ¶ 13).

Non-Party Ralph A. Zuzolo served as a Bank director and Corporate Board Secretary to the Bank from 1979 until his death on August 22, 2005. He was also a director of and Corporate Board Secretary to the Company from its formation until his death. He was the principal in the law firm of Zuzolo, Zuzolo & Zuzolo, which often provided legal services to First Niles and the Bank. Zuzolo was also the Chief Executive Officer and 100% owner of American Title Services, Inc. ("American Title"), a real estate title agency located in Niles, Ohio. American Title provided title services in almost all of Bank's residential and commercial closings. Indeed, the Office of Thrift Supervision ("OTS") believed this conflict sufficiently material to require disclosure of it to all Bank loan applicants. This conflict was, however, never disclosed in any of the Company's SEC filings. (Compl. ¶ 14).

B. The Company's Long History of Providing Directors and Officers Liquidity Through Stock Buy Back Programs.

The Company has a long history of using share buy back programs to provide liquidity to retiring executives and Board members in need of cash. For example, a Company-sponsored stock buy back plan was used to purchase shares from defendant Kramer when he needed to convert his shares to cash. Kramer purchased -- with borrowed funds -- 30,000 First Niles common shares at the offering price of \$10 per share. He was also awarded 3,509 First Niles shares under the Company's 1999 Recognition and Retention Plan, as well as options to purchase an additional 8,772 shares at an exercise price of \$12.53 under the Company's 1999 Option Plan. During 2002, Kramer sold half of his purchased shares to the Company. In May 2003, Kramer sold the remaining half to the Company at a price of roughly \$16 per share -- far in

excess of what he paid -- as part of a Company sponsored stock buy back. No Form 144 for an affiliate stock sale was filed for this transaction. (Compl. ¶¶ 15-19).

Kramer's sell-off continued through and including June 10, 2004. Because he had no actual shares left, he converted his options and sold the shares that he purchased with those options back to the Company. Specifically, he simultaneously exercised options for the 8,772 shares referenced above and sold 7,500 shares to the Company at prices ranging from \$17.50 to \$18.30 per share. Through these transactions, Kramer realized \$109,913. When plaintiff Gantler asked Kramer why he sold these shares, Kramer replied: "I need the money." (Compl. ¶¶ 20-21).

Indeed, Kramer didn't even have the cash necessary to pay the option exercise price. Rather, defendants Stephens and Safarek allowed the Company to front the purchase price and then reduce Kramer's sale proceeds correspondingly. This "cash-less" exercise violated the Company's 1999 Option Plan, which requires full cash payment of the exercise price for the option shares purchased. Kramer also did not file a Form 144 with the SEC. Defendants Stephens, Safarek and Csontos knew of the improprieties with respect to Kramer's cash-less option exercise, but turned a blind-eye to these irregularities in an attempt to curry favor with Kramer and garner support for their management-friendly proposals. (Compl. ¶ 22).

C. The Board Authorizes a Sale Process and Actively Solicits Bids.

By the end of 2003, First Niles was experiencing little to no growth in its Bank assets, partly because of the depressed economy in the Bank's market area. Nevertheless, the Company was an attractive merger candidate because of its small size. Its operations were sufficiently antiquated that an experienced management team could easily modernize it to take full advantage of its existing customer base. (Compl. ¶¶ 24-26).

In recognition of these factors, the First Niles Board -- which at that time consisted of defendants Stephens, Kramer and Eddy; non-party Zuzolo; and plaintiff Gantler -- invited investment bankers to make proposals regarding strategic opportunities available to the Company. These bankers recommended that the Company put itself up for sale and look for potential acquisition partners. (Compl. ¶ 27).

In August 2004, the Company's Board authorized the sale process to commence. It retained the same investment bank that handled the Bank's demutualization, Keefe, Bruyette & Woods ("KBW"), to serve as the Company's financial advisor. (Compl. ¶ 28).

Immediately after the sale process was authorized, defendant Stephens got cold feet. A sale would mean the end of his dominance at the Bank. It would also likely leave his foot soldiers -- defendants Csontos and Safarek -- without jobs. Consequently, on September 7, 2004, the very next Board meeting following the sale authorization, defendants Stephens, Csontos and Safarek made a proposal urging the Board to abandon the sale process and embrace a proposal similar to the now-advanced Reclassification. This proposal included plans to delist First Niles stock from the NASDAQ SmallCap Market, switch Home Federal from a federally chartered savings and loan to a state-chartered savings bank, and reincorporate the Company in Maryland. No action was taken on this officer-sponsored proposal at the September 7, 2004 Board meeting. (Compl. ¶ 29).

The Company continued with the sale process. On September 10, 2004, it entered into a formal retention letter with KBW that specifically charged KBW with soliciting and negotiating bids on the Company's behalf. On December 10, 2004, three institutions -- First Place Financial Corp. ("First Place"), Farmers National Banc Corp. ("Farmers") and Cortland Bancorp ("Cortland") responded to Stephens with written bid letters. (Compl. ¶¶ 30-31).

The Farmers offer specifically noted it had “no plans to retain the current First Niles board . . .” It was not pursued. (Compl. ¶ 32).

Cortland, a 13-branch bank headquartered in Cortland, Ohio, offered the equivalent of \$18 per First Niles share in a mixture of 49% cash and 51% stock. This offer represented a 3.4% premium over First Niles’ then-current market value. In its written indication of interest, Cortland explained that it would terminate all current First Niles Board members but give them future consideration as board openings arose. Cortland also indicated that it would not retain defendants Stephens, Csontos and Safarek. (Compl. ¶ 33).

First Place, an Ohio-based bank with 27 branches, offered to purchase the Company in a stock transaction valued at \$18 to \$18.50 per First Niles share. This price represented a premium of 3.4% to 6.3% over First Niles’ then-current market value. The First Place offer did not mention whether First Niles’ directors would be offered board seats with the combined entity. (Compl. ¶ 34).

Chairman Stephens did not call a meeting or forward these bids to the rest of the Board immediately. Rather, he waited until the next regularly scheduled Board meeting -- ten days later on December 20, 2004 -- to address the potential sale. When the issue was finally raised, KBW opined that the consideration offered by all three bidders was well within the ranges supported by their financial models. KBW further indicated that the upside for shareholders by exchanging partial or all stock was stronger than the prospects for First Niles stock over the long term. The Board made no decision at this time with respect to either the Cortland or First Place proposal. KBW did, however, try to impress upon the Board that any delay in responding to these offers would be highly unusual. (Compl. ¶ 35).

Knowing that the issue of the sale would be raised at the December 20 Board meeting, management used the opportunity to refocus the Board's attention to their self-interested scheme. Defendant Stephens provided each of the directors with a copy of a document entitled "Board Meeting of December 20, 2004 -- FNFI Potential Price in Three Years." Stephens attributed authorship to defendant Safarek. This document included recommendations similar to those contained in the September 7, 2004 officer-sponsored proposal. It included a Company-sponsored share buy back program to allow for delisting, as well as other detailed costs savings, the majority of which were to be achieved by obtaining a state bank charter, eliminating OTS regulatory requirements and converting from a Delaware to a Maryland corporation. (Compl. ¶ 36).

By January 4, 2005, First Place still had not heard back from First Niles in response to its December 10 bid letter. Stephen R. Lewis, the Chief Operating Officer of First Place, wrote to defendant Stephens reminding him of the First Place offer. Lewis indicated that "First Place 'currency' has value and will continue to appreciate as [First Place's] business continues to grow and evolve." He noted that the First Place balance sheet has diversified extensively to create more profitable business lines, as well as a more balanced approach to revenue growth in asset and funding base. Finally, Lewis relayed his belief that First Place's multiple would continue a positive trend, a factor that analysts had relied upon in forming a positive outlook for First Place. (Compl. ¶ 37).

D. Defendants Stephens, Csontos and Safarek Sabotage Due Diligence.

On January 18, 2005, the Board directed management and KBW to proceed with due diligence as to both First Place and Cortland. Despite this direction, management provided no communication what-so-ever to the Board as to the implementation of the due diligence

process and, as confirmed by subsequent events, management had no intention of ever initiating or cooperating with the due diligence process. In a letter documenting KBW's continuing discussions with First Place, KBW urged management to step up its efforts -- warning "[m]omentum is now important and I do not want to lose any." The letter also noted that the First Place bid offered First Niles' stockholders an opportunity for liquidity. KBW concluded that First Place had made a proposal that KBW "strongly encouraged [the company] not to dismiss." (Compl. ¶¶ 39-40).

Thereafter, KBW met with defendants Stephens and Safarek to impress upon them the need to cooperate in due diligence. At this meeting, the participants reviewed Cortland's due diligence requests. It was agreed that defendants Stephens and Safarek would promptly collect and supply Cortland -- through its investment banker -- the requested information. Due diligence sessions were scheduled for February 6, 2005. (Compl. ¶ 41).

Despite knowledge of the importance of the sale and the need for due diligence, defendants Stephens and Safarek did not collect the requested materials. On February 3, 2005, Cortland called First Niles, through KBW, to inquire regarding the status of due diligence documents. When Cortland learned that nothing had been collected, they cancelled the previously scheduled February 6 due diligence review session. Cortland further demanded cooperation, urging that all materials be submitted to them by no later than February 8. (Compl. ¶ 42).

Company management did not comply with this deadline. Nor had they done so two days later. As a result, on February 10, 2005, Cortland called KBW and withdrew its letter of intent. The lead banker at KBW confirmed that Cortland's withdrawal could be attributed to

“the inordinate amount of delay on the part of [First Niles] management getting/ not getting information to Cortland.” (Compl. ¶ 43).

Assured that one proposal that would leave them unemployed was scuttled, defendants Stephens, Safarek and Csontos approached the First Place due diligence with the same lack of alacrity. First Place provided the Company with due diligence requests on February 7, 2005. Around the same time, First Place suggested due diligence review sessions on February 15 or 16. KBW immediately passed this request along to defendant Stephens to confirm his availability. Stephens did not respond. KBW then called Stephens again in an effort to get him to commit to due diligence. Stephens begged off. Despite the obvious importance to shareholders of securing a bid that the Company’s bankers had already opined was within its valuation parameters, Stephens claimed that other bank business was more pressing. KBW became more emphatic, explaining that First Place must be a strong priority. Still, Stephens would not commit to a due diligence meeting. (Compl. ¶¶ 44-45).

When Cortland withdrew from the process, KBW again attempted to communicate to Company management the importance of scheduling due diligence. Stephens still refuse to commit. He indicated that he would get back to KBW the next morning. Despite his promises, by 11:30 a.m. the next morning, Stephens had still not called KBW. KBW phoned him again trying to convince him that it was imperative to provide due diligence. Finally, Stephens consented and due diligence sessions were scheduled. (Compl. ¶ 46).

From the time that due diligence was authorized until the time that Cortland pulled its bid, there was no communication from First Niles management to the Board of any information concerning the status of the due diligence process or any of the difficulties that KBW encountered as a result of the management’s lack of cooperation. (Compl. ¶ 47).

E. First Place Makes a Definitive, Value-Maximizing Offer that is Rejected in Favor of Alternatives that Would Allow Defendants to Retain Their Jobs and Board Positions.

On February 13, 2005, First Place -- the one remaining bidder -- began its due diligence review. On March 4, 2005, First Place submitted a revised offer to purchase the Company with First Place stock (the "March 4 First Place Proposal"). The March 4 First Place Proposal featured a 7% increase, to 0.8439, in the exchange ratio previously indicated. Because of declines in First Place's stock price since the December 10 bid, this exchange ratio implied a value of \$17.25 per First Niles share. Given that the First Niles share price had also dropped and more precipitously, the \$17.25 First Place proposal still represented a sizable premium over First Niles' then-current trading price of \$15.50. Indeed, even at the lower nominal price, the revised First Place offer provided First Niles stockholders with improved economics. Specifically, the March 4 First Place Proposal indicated pro forma effective earnings per share for First Niles that were 17.9% above its expected stand-alone performance and a pro forma effective book value for First Niles that was 8.3% higher than the Company's expected stand-alone book value, representing an increase of about \$1 per share. At \$17.25, the First Place deal value exceeded all of the average and median metrics KBW employed in its analysis based on comparable transactions involving thrifts with assets less than \$225 million. The core deposit ratio observed by KBW at that price exceeded the mean comparables multiples by 100%. These factors again led KBW to conclude that the "M&A comps groups support that the consideration is well within the ranges -- in fact, even above given the high level of equity and certainly with respect to the core deposit premium." (Compl. ¶¶ 48-49).

KBW immediately forwarded the March 4 First Place Proposal to First Niles Board members. Chairman Stephens made no effort, however, to convene a special Board meeting. (Compl. ¶ 50).

On March 7, 2005, the Board met in regular session. Although there is no mention of any discussion of the First Place March 4 Proposal in the minutes of the March 7, 2005 Board meeting, there was a conference call that followed the meeting. It was attended by members of the First Niles Board, KBW and Company counsel. At that meeting, KBW reviewed the First Place proposal and indicated its view that there might be a possibility of a further upward adjustment in the exchange ratio. No discussion ensued among the Board following the KBW presentation. Rather, the chair of the meetings, Stephens, summarily thanked the KBW representative for his presentation and informed him that the Board would review that matter at its next scheduled meeting. KBW opined that the Board's deferring consideration of the proposal for another two weeks would in all likelihood be unacceptable to First Place. Stephens then suggested that a special Board meeting be scheduled for March 9, 2006, to address the First Place proposal, and adjourned the meeting. (Compl. ¶ 51).

In a March 8, 2005 Memorandum, KBW reported back to the Board that it was successful in securing yet another increase in the exchange ratio that First Place offered. The new definitive merger proposal was for a stock transaction at 0.85 shares of First Place stock for each share of First Niles stock (the "First Place Definitive Merger Proposal"). Given First Place's then-trading price, this adjustment implied an increase in the offer price to \$17.37 per share. KBW was very positive about the increase and the price. It noted that shareholders could expect to receive in the near term between \$25.52 and \$30.61 if the First Place Definitive Merger Proposal was adopted. (Compl. ¶ 52).

Stephens did not disseminate the March 8, 2005 Memorandum to the other Board members until the March 9, 2005 Board meeting. (Compl. ¶ 53).

At the March 9, 2005 Board meeting, Stephens stated that the First Niles stock price was not a concern of his and implied that he had no interest in the First Place Definitive Merger Proposal or any other acquisition proposals. Without any discussion or deliberation whatsoever, Stephens called the vote on the Definitive Merger Proposal. Acting against the advice of the Company's financial advisor and solely for their own self-interest, the First Niles Board rejected First Place's value-maximizing bid by a vote of 4-1. Only plaintiff Gantler voted in favor of the First Place Definitive Merger Proposal. (Compl. ¶ 54).

Immediately after the vote on the First Place Definitive Merger Proposal was called and as if the outcome had been previously known, Chairman Stephens moved to a discussion of implementing his preferred alternative -- deregistration. He raised the possibility of delaying the Company's annual shareholders meeting in order to enable shareholders to vote on deregistration. The Company's lawyers were immediately tasked with investigating this self-serving option. This investigation included consideration of a change in domicile of the Company, reincorporation outside of Delaware and transfer of the Bank from a federally chartered to state-chartered bank. (Compl. ¶ 55).

By voting the sale down, defendants secured important personal benefits.

- Stephens maintained his long-held positions as Chief Executive Officer and Board Chairman of a prominent community thrift. (Compl. ¶ 56).
- Kramer insured the continuation of a position from which he had received enormous financial benefit, having previously sold 37,500 shares of stock at prices ranging up to \$18.30 to satisfy his need for cash. The opportunity for further stock buybacks to hold him over in a tight period was also secured. In addition, he protected Stephens, a benefactor who had accommodated these stock sales even in violation of SEC regulations and the Company's 1999

Option Plan. Finally, Kramer maintained his future director's fees and Bank heating and air conditioning work. (Id.).

- Zuzolo secured the opportunity to continue to provide legal services for the Company. More importantly, Zuzolo knew that First Place had its own title service company that competed with his American Title. Rejection of the First Place offer insured that the Bank would continue to use the services of American Title, securing a substantial source of income for Zuzolo. (Id.).
- Eddy once again failed to exercise any independent judgment, instead choosing to comply with whatever was requested of him by Stephens and Kramer. (Id.).

Defendants' self-interested actions denied plaintiffs the benefit of the First Place Definitive Merger Proposal and any opportunities that may have resulted from due diligence by Cortland. (Compl. ¶ 57).

F. Defendants Continue to Pursue their Self-Interest Through the Reclassification.

At a Board meeting held on April 18, 2005, defendant Stephens stepped up his efforts to pursue reclassification. He furnished to directors a preliminary report prepared by the Company's lawyers; an engagement letter dated March 23, 2005 for Powell Goldstein LLP ("Powell Goldstein"), a law firm which specializes in privatizing community banks; and a document titled "First Niles Financial, Inc. Privatization Proposal." (Compl. ¶ 59).

The Privatization Proposal indicated that it was management's recommendation, as well as the recommendation of the Company's unnamed general counsel, that a plan nearly identical to the Reclassification be adopted. Specifically, the Privatization Proposal advocated reclassifying shareholders with 300 or fewer common shares as preferred shareholders on a one-to-one share basis. The new class of preferred shareholders would surrender voting rights in exchange for a slightly higher quarterly dividend, would retain voting rights in a sale of the Company and would have the same liquidation rights as common stock. Powell Goldstein was recommended to do the necessary legal work. (Compl. ¶ 60).

The Privatization Proposal claimed that the reclassification method was superior to other alternatives, such as a reverse stock split or tender offer, because it best suited management's needs. *In particular, the Privatization Proposal advocated reclassification because it allowed maximum flexibility for future capital management activities, such as open market purchase and negotiated buy backs.* Reclassification also would not subject any shares to a Section 262 appraisal proceeding (Compl. ¶ 61).

At the April 18, 2005 Board meeting, Zuzolo suggested that issues related to the Privatization Proposal be further discussed at the next Board meeting. Immediately after the April 20, 2005 annual meeting, the First Niles Board met in executive session. At that meeting, director Zuzolo was appointed to chair a committee (the so-called "Zuzolo Committee") tasked with thoroughly researching and preparing a report for the full Board addressing any and all issues relating to the procedures and costs involved in: (1) reincorporating the Company in a state other than Delaware; (2) changing the Bank's charter from a federal charter to a state charter; (3) deregistering from NASDAQ; and (4) delisting. (Compl. ¶¶ 62-63).

On August 22, 2005, Zuzolo passed away. From April 20, 2005 to the date of Zuzolo's death, no one was appointed to the Zuzolo Committee and Zuzolo never submitted any oral or written findings, let alone any formal report, to the Board. Nevertheless, just days after Zuzolo's passing, defendant Kramer wrote to the Company's controller stating that a "privatization" was imminent. Obviously, he assumed that defendant Stephens's preferred course of action would come to fruition even without a report or recommendation. (Compl. ¶¶ 64-65).

At a Board meeting on or about October 3, 2005, and without the benefit of any report from Zuzolo's purported committee, defendant Stephens urged the Board to proceed with

reclassification and deregistration. Management was present and made a similar recommendation. Plaintiff Gantler expressed concerns regarding the personal advantages that defendants would achieve in any such transaction and, given the conflict of interest created by such benefits, the lack of independent representation for the unaffiliated shareholders. Management and the Board rebuffed Gantler's efforts to pursue independent representation. (Compl. ¶ 66).

On December 5, 2005, the First Niles Board again met in regular session. Two lawyers from Powell Goldstein, defendant Safarek and defendant Csontos were also present. The Powell Goldstein lawyers led a discussion regarding First Niles' corporate structure, deregistration and going private. A discussion of a reclassification of shareholders to ensure common shareholding by less than 300 holders of record ensued. Few details and no written plan were presented. Plaintiff Gantler expressed his concerns as to compliance with SEC Rule 13e-3, disclosure of the aborted sale process, disclosure of the Kramer stock sales, the conflict of interest created by certain defendants' ESOP holdings, the lack of independent representation for the unaffiliated shareholders and the absence of a fairness opinion. The Powell Goldstein lawyers replied that all issues would be considered, and then requested a vote by the Board. Defendants Eddy, Kramer and Stephens -- all of whom stood to gain from the reclassification -- voted affirmatively "to have Powell Goldstein LLP to go forward with a stock reclassification program in order to deregister from the SEC, and its requirements." Plaintiff Gantler voted against. (Compl. ¶ 67).

On April 26, 2006, First Niles held its annual meeting to elect directors. Plaintiff Gantler, who had voted in favor of the value-maximizing First Place sale that threatened Stephens job and against Stephens' preferred reclassification proposal, was not nominated by the

Board for re-election. Rather, the Board endorsed long-time officer and proponent of the reclassification -- Csontos -- to fill his seat. At all times thereafter, the Board consisted of defendants Stephens, Kramer, Eddy, Shaker and Csontos. (Compl. ¶ 68).

G. The New Board and the Company's Officers Pursue and Recommend that Shareholders Adopt the Reclassification.

In June 2006, the Board met twice to discuss reclassification. The Board, which included defendants Csontos and Shaker, *unanimously* approved amendments to the Company's Charter (the "Articles of Amendment"), which provide for the reclassification of each share of First Niles common stock held by shareholders who are the record holders of 300 or fewer shares of common stock, into one share of Series A Preferred Stock (the "Preferred Stock"). (Compl. ¶ 69).

The Board further approved new terms for the Preferred Stock, which if authorized by the Company's shareholders, would allow the Preferred Stock to rank senior to the common stock with respect to dividend rights, as well as rights upon liquidation, dissolution or winding up of the Company. The new Preferred Stock authorized by the Board would have no voting rights except with respect to certain change-of-control proposals. The Preferred Stock also would automatically convert to shares of common stock immediately prior to certain change of control transactions (Compl. ¶ 69).

Finally, the Board and members of management (including each of the individual defendants), determined that the Reclassification was fair to the Company's unaffiliated shareholders. The Board defendants adopted a resolution recommending that shareholders vote in favor of the Articles of Amendments. (See, e.g., Proxy at 5-6, 7, 15, 23-24, 30<sup>1</sup>; see also

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<sup>1</sup> Specifically, the Proxy (at 30) states that: "Our affiliates consist of our directors and executive officers: William L. Stephens, P. James Kramer, Lawrence Safarek, Robert I.

Compl. p. 25 and at ¶ 89 (noting that all defendants are “filing persons” with respect to the Proxy and that all defendants urged the shareholders to vote in favor of the Reclassification)).

H. Defendants File a Series of Misleading Proxies Urging that Shareholders Vote in Favor of the Articles of Amendment and the Reclassification.

To ensure that the self-serving Reclassification was approved, defendants submitted a series of misleading proxies that urged shareholders to vote in favor of the Articles of Amendment and the Reclassification. (Compl. ¶¶ 78-80).<sup>2</sup> Based on these false statements and material omissions, the Reclassification was approved.

I. The Effects of the Reclassification.

As a result of the Reclassification, the total number of record holders of First Niles’ common stock fell below 300, thus permitting the Company under SEC guidelines to terminate the registration of its common stock. The Company is now no longer quoted or traded on the NASDAQ SmallCap Market, or readily tradable on any established market. (Compl. ¶ 70).

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Shaker, Daniel E. Csontos, William S. Eddy. These affiliates are deemed to be ‘filing persons’ for the purposes of this transaction. . . . each of our affiliates had concluded that the Rule 13e-3 transaction is procedurally and substantively fair to our unaffiliated shareholders who will retain their shares of common stock.” Ex. A to Brief in Support of Defendants’ Motion to Dismiss Plaintiffs’ Amended Complaint [hereinafter “DOB at \_\_\_”]

<sup>2</sup> Plaintiffs’ initial complaint noted a number of false statements and omissions in the defendants’ preliminary proxies, including: that they failed to disclose that plaintiff Gantler opposed the Reclassification; falsely stated that, at the December 5, 2005 meeting, the “board *unanimously* approved pursuing a stock reclassification rather than a cash-out merger;” and falsely described the never-before disclosed sale process by, among other things, claiming that the Company did not seek “any proposals from third-parties for any business combination transaction such as a merger, consolidation, or sale of all or substantially all of our assets,” despite the history of a Board-authorized sale process. The Proxy corrects these and other, but not all, material omissions and false statements (see generally Compl. ¶¶ 78-80).

Although none of plaintiffs' shares were reclassified, they suffered and continue to suffer real damage as a result of defendants' scheme. The market that existed for First Niles common stock has been eliminated. Plaintiffs have access to less information about the Company. The corporate governance safeguards resulting from the Sarbanes-Oxley Act and NASDAQ listing requirements are no longer applicable. Additionally, the Company is a less desirable takeover candidate as a result of the Reclassification. Thus, plaintiffs have been left with an illiquid security, subject to defendants' future efforts to impair their equity interests. (Compl. ¶ 71).

Through the Reclassification, defendants (none of whose shares were converted) achieved numerous benefits not shared equally with the unaffiliated shareholders. They are no longer subject to the restrictions or liabilities under the Securities Act. Information about the defendants' compensation and stock ownership is no longer publicly available. The percentage of beneficial ownership of First Niles common stock held by First Niles directors and officers as a group increased. Reclassification, unlike the sale alternative defendants rejected, insured defendants' continued employment, perquisites and directorships. (Compl. ¶ 73).

*Moreover, as specifically noted in the Privatization Proposal, the Reclassification will increase defendants' flexibility to negotiate Company buy backs of each others' shares and options. This flexibility insures that defendants will not be subject to the same illiquidity crisis facing the unaffiliated stockholders.* (Compl. ¶ 74).

The Reclassification also promises defendants Stephens, Csontos and Safarek even greater liquidity. Each of these defendants holds a significant amount of their First Niles Stock through the Company's ESOP. The ESOP provides that "[i]n the event that the Employer Securities distributed to a Participant are not readily tradable on an established market, the

Participant shall be entitled to require that the Employer repurchase the Employer Securities under a fair valuation formula, as provided by government regulations” (ESOP at § 8.7 “Put Option”) (Compl. ¶ 76). As a result of the fact that post-Reclassification First Niles’ stock will no longer “be readily tradable on an established market,” defendants Stephens, Csontos and Safarek will enjoy the right to put their shares held through the ESOP to the Company at fair value. (Compl. ¶ 75). Thus, the Reclassification affects plaintiffs and defendants very differently. *Post-Reclassification plaintiffs’ First Niles’ shares will be basically illiquid while defendants can rely on stock buy backs and/or the ESOP fair value put right to insure that their First Niles’ investment can be converted to cash.*

Despite the defendants’ obvious interest in the Reclassification, it was pursued without any procedural protections for the stockholders unaffiliated with management and the defendant directors. The Board did not establish a special committee of directors charged with representing the unaffiliated stockholders. The Board did not retain outside counsel to represent the unaffiliated stockholders. The Board did not consult with a financial advisor. (Compl. ¶ 77).

## ARGUMENT

A motion to dismiss pursuant to Court of Chancery Rule 12(b)(6) must be denied “unless it can be determined with reasonable certainty that the plaintiff could not prevail on any set of facts reasonably inferable from the complaint’s allegations.” Superwire.com, Inc. v. Hampton, 805 A.2d 904, 908 (Del. Ch. 2002) (citing Solomon v. Pathe Communications Corp., 672 A.2d 35, 38 (Del. 1996)); see also id. at 912 (“it is sufficient under the general notice pleading standard found in Court of Chancery Rule 8(a) that the complaint ‘contain . . . a short and plain statement that the pleading is entitled to relief’”); Rabkin v. Phillip A. Hunt Chem. Corp., 498 A.2d 1099, 1104 (Del. 1985) (“[a] complaint need only give general notice of the claim asserted”). The Court must “assume the truthfulness of the well-pled allegations of the complaint” and give the pleader “the benefit of all reasonable inferences that can be drawn from its pleadings.” Superwire.com, 805 A.2d at 908 (quoting In re USA Cafes, L.P. Litig., 600 A.2d 43, 47 (Del. Ch. 1991)). “What this effectively means is that the Court must consider the various factual permutations reasonably possible within the framework of plaintiff’s allegations and conclude whether any one conceivable set of facts could possibly merit granting [the] plaintiff relief. If so, the claim cannot be dismissed.” In re Primedia Inc. Derv. Litig., 910 A.2d 248, 256 (Del. Ch. 2006) (quoting In re New Valley Corp. Derv. Litig., 2001 WL 50212, at \*4 (Del. Ch.)).

### I. COUNTS I AND III OF PLAINTIFFS’ COMPLAINT STATE CLAIMS FOR BREACH OF THE DUTY OF LOYALTY

In their brief, defendants attempt to hide behind the business judgment rule to shield their self-interested acts from judicial scrutiny. The business judgment rule’s presumption that a board acted loyally is rebutted where, as here, the well-pled allegations of a complaint support the inference that the board was interested in the outcome or lacked the independence to

consider objectively whether a transaction was in the best interest of its company and all of its shareholders. See Orman v. Cullman, 794 A.2d 5, 22 (Del. Ch. 2002). Because the Complaint adequately alleges that a majority of the First Niles Board was interested and/or lacked independence -- both at the time the sale process was terminated and the Reclassification was adopted -- Counts I and III state sustainable claims for breach of the fiduciary duty of loyalty that are not subject to dismissal.

A. Count I – the Sale Claim.

Count I of the Complaint alleges that defendants Stephens, Kramer, Eddy, Csontos and Safarek breached their fiduciary duties when they acted solely to preserve their positions as directors and officers of the Company by sabotaging due diligence, rejecting the value-maximizing First Place Definitive Merger Proposal and terminating the Company’s exploration of sale opportunities. Delaware Courts have held such entrenching activities to be sufficient to deny fiduciaries the protection of the business judgment rule and warrant heightened scrutiny from this Court. See, e.g., Unocal v. Mca Petroleum Co., 493 A.2d 946 (Del. 1985) (“Because of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred”); Chrysogelos v. London, 1992 WL 58516, at \*6 (Del. Ch.) (“if corporate directors ‘[manipulate] the corporate machinery . . . for the sole or primary purpose of perpetuating themselves in office,’ they violate a fiduciary duty owed to the corporation and its shareholders”) (citation omitted); see also California Pub. Employees’ Ret. Sys. v. Coulter, 2002 WL 31888343, at \*8 (Del. Ch.) [hereinafter CALPERS] (“Directors are presumptively ‘interested’ in such actions taken for entrenchment purposes”).

Even without the application of this heightened scrutiny, plaintiffs' Complaint adequately alleges facts, when viewed in their totality, demonstrate that defendants Stephens, Kramer, Zuzolo and Eddy (four of the five First Niles Board members at the time of the wrongful acts) were interested and lacked independence.

- Stephens: Defendants appear to concede that the loss to Stephens of his long-held positions as Chief Executive Officer and Board Chairman constitutes a material, detrimental impact not shared equally with the First Niles Shareholders, rendering him interested. See Rales v. Blasband, 634 A.2d 927, 936 (Del. 1993) ("Directorial interest also exists where a corporate decision will have a materially detrimental impact on a director, but not on the corporation and the stockholders. In such circumstances, a director cannot be expected to exercise his or her independent business judgment without being influenced by the adverse personal consequences resulting from the decision."). Indeed, Delaware Courts have repeatedly held that the "compensation from one's full-time employment is 'typically of great consequence' to the recipient," making the recipient interested in opposing any transaction that would threaten it. In re Primedia, 910 A.2d at 261 n.45 (quoting In re The Student Loan Corp. Derv. Litig., 2002 WL 75479, at \*3 n.3 (Del. Ch.)).<sup>3</sup> Certainly Stephens' actions in delaying Board decisions with respect to bids (against the advice of his financial advisors) (Compl. ¶¶ 35, 50, 51, 53), sabotaging due diligence (Compl. ¶¶ 39-47), and proposing an alternative transaction that would

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<sup>3</sup> Officer defendants Csontos and Safarek also acted to maintain their livelihood and employment when they proposed that the Board abandon the sale process and embrace a proposal similar to the now-adopted Reclassification, as well as when they intentionally sabotaged due diligence and caused at least one bidder to withdraw from the sale process (see Compl. ¶¶ 29, 36, 39-47; see also Compl. ¶¶ 11, 12). The business judgment presumption cannot protect these officer defendants from liability for Count I.

insure that his position as Chief Executive Officer and Board Chairman were secure (Compl. ¶¶ 29, 36, 55), evidence his personal interest in insuring that the First Place merger was rejected.<sup>4</sup>

- Kramer: Plaintiffs' Complaint pleads that Kramer's vote against the First Place bid assured that he would retain the position from which he received enormous financial benefit and could be expected to receive even greater financial benefit in the future, rendering him interested (Compl. ¶¶ 9, 15-22, 56). These future benefits included the opportunity for stock buy backs to hold him over when money was tight, as well as the potential for full-time employment, directors' fees, stock grants and options (from which he had already reaped \$109,913) and Bank heating and air conditioning work (Compl. ¶¶ 9, 15-22, 56). For Kramer, a man of modest means in need of money, these benefits were material (see Compl. ¶¶ 9, 21-22).<sup>5</sup>

In the face of these well-pled allegations, defendants claim that "mere receipt of directors' fees does not establish interestedness." (DOB at 12). Defendants' argument "oversimplifies Delaware law" and ignores the totality of the well-pled allegations of the Complaint. In re Nat. Auto Credit, Inc. S'holders Litig., 2003 WL 139768, at \*10 (Del. Ch.) (finding that directors were interested as a result of their directors' fees); see also Grobow v. Perot, 526 A.2d 914, 923 n.12 (Del. Ch. 1987), aff'd, 539 A.2d 180 (Del. 1988) (the rule that "mere" directors' fees do not create a disabling interest "is not an unvarying principle that mechanically applies irrespective of the circumstances."). Plaintiffs do not claim the mere

<sup>4</sup> Stephens further covered his tracks by failing to report anything with respect to the sabotaged sale process to shareholders until November, 2006, a year and a half and 28 SEC filings later (Compl. ¶ 58). When the sale process was finally made known to the shareholders, the disclosures were inaccurate and misleading (Compl. ¶ 82).

<sup>5</sup> These facts stand in sharp contrast to those alleged in Pogostin v. Rice, 480 A.2d 619 (Del. 1984), the case upon which defendants rely (see DOB at 11-12). The complaint at issue in Pogostin included nothing more than the conclusory allegation that the Board rejected a hostile bid and, therefore, must be acting for the purpose of entrenching themselves in office. 480 A.2d at 626.

prospect of continued directors' fees colored Kramer's judgment. Rather, it was the cumulative effect of all future benefits, including not only the directors' fees but the opportunity for future stock buy backs, full time employment, stock options grants and heating and air conditioning work, that rendered him interested.

Indeed, defendants almost completely ignore one aspect of plaintiffs' allegations -- those detailing Kramer's continued interest in having the Company buy back his stock, which would have been eliminated had the First Place offer been accepted. The Complaint alleges that the First Niles Board had a long history of buying back directors' and officers' stock at favorable prices (Compl. ¶¶ 15-23 (noting that in June 2004, Kramer simultaneously exercised options for 8,772 shares and sold 7,500 shares to the Company at prices ranging from \$17.50 to \$18.30 per share; see supra, at 5-6)). Kramer took advantage of this program when he needed cash, trading stock granted to him in return for his services for almost \$110,000. (Compl. ¶¶ 20-21). There can be no doubt that acceptance of the First Place bid would have ended the possibility of such above-market buy backs, thereby capping the amount that Kramer would receive for his First Niles stock at the same price that all other shareholders would receive (about \$17.25). Indeed, the documents reflect, and the Complaint specifically alleges, that the Board pursued the Reclassification as an alternative to the sale "because it allowed maximum flexibility for future capital management activities, such as open market purchases and negotiated buy backs" (Compl. ¶ 61).

Defendants assert only one rebuttal argument with respect to the obvious interest created by Kramer's share buy back opportunity. Relying on Nebenzahl v. Miller, 1993 WL 488284 (Del. Ch.), defendants argue that attempting to benefit from already existing practices cannot create an inference of interest (DOB at 15). Defendants' reliance on Nebenzahl, here,

where plaintiffs allege that defendants acted to entrench themselves and prevent termination of an existing practice, is misplaced. Plaintiff in Nebenzahl argued that certain director defendants were interested in a challenged merger because they would receive golden parachute payments pursuant to their employment agreements. The Court rejected this claim, recognizing that any payments would be made pursuant to pre-existing contractual arrangements that would be triggered in any merger. Id. at \*3-4. That is, plaintiff could not prove the necessary connection between defendants' approval of the merger and the benefit they received. See also Orman, 794 A.2d at 29-30 (making same distinction because, even if merger were not consummated, directors would have same right to enforce contract). In contrast, there can be no doubt that acceptance of the First Place bid here would have insured that the Company would not buy back Kramer's stock at higher prices in the future. Thus, rejection of the First Place bid benefited Kramer in a way not shared by the other stockholders by continuing the possibility of such buy-backs in the future.

Defendants next argue that plaintiffs have not alleged facts demonstrating that the package of benefits Kramer insured for himself by opposing the First Place bid was material to him (DOB at 12-13, 14-15).<sup>6</sup> In support of this argument -- as well as so many others in their brief -- defendants' rely almost exclusively upon cases applying the more stringent "particularity" pleading standard of Rule 23.1, which is not applicable on this motion to dismiss.<sup>7</sup>

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<sup>6</sup> Defendants' (DOB at 12-16) wrongfully evaluate whether each of the alleged benefits that Kramer will receive from First Niles remaining independent is material to him rather than considering the impact of these benefits as a whole. CALPERS, 2002 WL 31888343, at \*9.

<sup>7</sup> See DOB at 12 (citing Khanna v. McMinn, 2006 WL 1388744 (Del. Ch.) (Rule 23.1) and Benihana of Tokyo, Inc. v. Benihana, Inc., 891 A.2d 150 (Del. Ch. 2005), aff'd, 906 A.2d 114 (Del. 2006) (post-trial)); DOB at 13 (citing In re Walt Disney Co. Deriv. Litig., 731 A.2d 342 (Del. Ch. 1998), rev'd in part on other grounds by Brehm v. Eisner, 746 A.2d

See, e.g., In re Primedia, 910 A. 2d at 256 n.13 (noting that “the ‘reasonable doubt’ standard used in a demand futility analysis provides a higher hurdle for a plaintiff than the relatively lenient standard of review pursuant to Rule 12(b)(6)”); In re Nat. Auto Credit, 2003 WL 139768, at \*12 (Del. Ch.) (noting that a Rule 12(b)(6) motion presents a more lenient standard than a Rule 23.1 motion, which requires plaintiff to plead with particularity). This flaw is fatal to defendants’ argument.

Moreover, even in the more stringent context of a Rule 23.1 motion, Delaware Courts have urged “realism” in evaluating a complaint’s allegations regarding a defendant’s net worth. For example, in Steiner v. Meyerson, 1995 WL 441999, at \*10 (Del. Ch.), Chancellor Chandler held that a director who was an attorney at a small-firm receiving substantial fees from an interested party could not properly exercise his business judgment. He stated:

Realism of the kind signaled by Rales requires one to acknowledge the possibility that a partner at a small law firm bringing in close to \$1 million in revenues from a single client in one year may be sufficiently beholden to, or at least significantly influenced by, that client as to affect the independence of his judgment.

Id.

To the same effect is In re National Auto Credit, Inc. Shareholders Litigation, 2003 WL 139768, at \*11 (Del. Ch.), wherein the Court held that an inference of materiality could be made, under the particularity standard of Rule 23.1, despite the fact that the complaint contained “no detailed showing” as to the directors “financial status.” See also In re the Limited

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244 (Del. 2000) (Rule 23.1); DOB at 14 (arguing that plaintiff must assert “particularized facts” citing Jacobs v. Yang, 2004 WL 1728521, at \*6 (Del. Ch. 2004), aff’d, 876 A.2d 902 (Del. 2005) (Table) (Rule 23.1) and Khanna). The one Rule 12(b)(6) case on which defendants rely (DOB at 13) is H-M Wexford LLC v. Encorp, Inc., 2003 WL 21254843, at \*1 (Del. Ch.). In Wexford, plaintiff’s complaint included nothing more than conclusory allegation that various benefits received were material. As discussed below, the Complaint here includes detailed facts regarding Kramer’s personal financial situation from which materiality can be inferred.

Inc. S'holders Litig., 2002 WL 537692 (Del. Ch.) (finding, in demand futility context, that consulting fees received were substantial to a senior university official without any showing as to his personal net worth); Orman, 794 A.2d at 30 (finding that \$75,000 in fees would be material to consultant without any showing of consultant's net worth based on inferences drawn from fact that consultant was Chairman and CEO of an eponymously named firm); In re Ply Gem Indus. Inc. S'holders Litig., 2001 WL 755133, at \*9 (Del. Ch.) (inferring that fee amounts were material to defendants' small law firm based on what appeared to be nothing more than the fact that the firm had two lawyers' names in its title), reargument denied, 2001 WL 1192206 (Del. Ch.); Friedman v. Beningson, 1995 WL 716762, at \*5 (Del. Ch.) (receipt of \$48,000 in consulting fees sufficient to render director interested, even under more stringent Rule 23.1 standards, without any particular allegations with respect to consultants' financial circumstances), appeal refused, 676 A.2d 900 (Del. 1996) (Table).<sup>8</sup>

Realistically viewed, there can be no doubt that the well-pled allegations of the Complaint support a reasonable inference that the benefits Kramer safeguarded by voting against the First Place bid were material to him. The Complaint alleges that Kramer is a man of "modest means" (Compl. ¶ 9). In support of this allegation, it recites that Kramer is a heating and air conditioning repairman, working for a small company owned by him and his family that operates in a small, economically depressed, middle-American town (Compl. ¶¶ 9, 24). The company's

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<sup>8</sup> As these cases demonstrate, defendants' suggestion (DOB at 14) that plaintiffs have to allege the amount of Kramer's salary to survive a motion to dismiss is just wrong. As Justice Hartnett recognized in his dissent in Brehm v. Eisner, 746 A.2d 244, 268 (Del. 2000), a Rule 23.1 case, plaintiffs should not be held to too high of a pleading standard because they face the nearly impossible task of pleading facts that are not public knowledge without the benefit of discovery. In this regard, it should be noted that facts regarding Kramer's (or any of the other individual defendant's) personal, financial circumstances are not discoverable through a Section 220 demand for the corporation's books and records.

major real asset is worth well under \$100,000 and is completely leveraged though a mortgage loan controlled by the defendant Bank (Compl. ¶ 9). Finally, Kramer has admitted that he needs money (Compl. ¶ 21).<sup>9</sup>

Against this blue-collar backdrop, protecting the \$13,300 that Kramer earned in directors' fees in calendar year 2005 and the almost \$110,000 that Kramer realized by selling stock that he received as compensation for his Board service back to the Company are sufficiently material to Kramer to render him interested. This is certainly so when these already quantified benefits are coupled with the continued possibility of more stock buy backs at prices above the First Place merger bid, additional stock grants, more board fees, additional business with the Bank and the prospect of future employment. Accordingly, Kramer could not exercise his business judgment with respect to the sale process free of the influence of possible adverse personal consequences.

Not only does the Complaint allege that Kramer suffers from a disabling conflict of interest but it also claims that Kramer lacked the independence necessary to exercise his business judgment without extraneous considerations or influence. Rales, 634 A.2d at 936-37 (appropriate independent inquiry is whether director would be subject to "extraneous considerations or influences," for example if the interested party was "in a position to exert considerable influence over" the director). Specifically, the Complaint alleges facts from which it can be inferred that Kramer felt a "sense of 'owningness'" to his patron, the self-interested Stephens. In re Primedia, 910 A.2d at 261 n.45 (citations omitted).

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<sup>9</sup> Indeed, Kramer did not even have adequate cash to purchase his initial \$300,000 First Niles investment or to pay the option exercise price when he converted his options, instead requiring First Niles to front the purchase money (Compl. ¶¶ 16, 22). Given all of these allegations, defendants' claim (DOB at 12) that plaintiffs have failed to properly support their "modest means" allegation is without merit.

As noted above, Kramer cashed in his Company options at a time when he needed money (Compl. ¶ 21). To help Kramer out, Stephens allowed First Niles to advance Kramer money to purchase his options, in violation of the Company's 1999 Option Plan (Compl. ¶ 22). Stephens did nothing to address Kramer's failure to file a Form 144 (which would have revealed the improprieties of the "cash-less" exercise). From these facts, it is reasonable to infer that Kramer's support for Stephens' self-interested decision to sabotage the sale process and retain control of the Company was a *quid pro quo* for Stephens' turning a blind-eye to certain irregularities with respect to Kramer's Company stock purchases. See In re The Limited, 2002 WL 537692, at \*7 (noting that the determination of whether a particular director is "beholden" to another is "not limited to the power to affect the director in the future. One may feel 'beholden' to someone for past acts as well.").

The Complaint also alleges that Kramer is considering accepting a full-time job with the Bank (Compl. ¶ 9). This prospect of future employment renders him beholden to Stephens, who as CEO, can control all non-officer hiring decisions. Compare CALPERS, 2002 WL 31888343, at \*9-10 (explaining that director was beholden to interested director who was his superior); Rales, 634 A.2d at 937 (finding no independence where Rales brothers controlled the employment of non-interested directors); Orman, 794 A.2d at 42 n.50 (noting that an officer may be beholden to those who can control his employment).

In the face of these allegations, defendants' brief makes only one attack on Kramer's well-pled lack of independence.<sup>10</sup> They argue that Stephens is not capable of

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<sup>10</sup> Relying again on (factually irrelevant) Rule 23.1 case law, defendants also make a half-hearted attempt to argue that Kramer's consent to false disclosures regarding Stephens' compensation does not render him beholden to Stephens (DOB at 9). While this fact demonstrates action on Kramer's part consistent with a sense of "owningness" to

“controlling” Kramer or any other director’s fate because his shareholdings do not exceed 8% (DOB at 10-11). Delaware courts, however, have rejected long ago the argument that only where the corporation has a controlling shareholder can directors fall under the influence of another. Steiner v. Meyerson, 1995 WL 441999, at \*9-10. Rather, established case law adopts a “realistic and less formal” approach that considers whether the allegedly dominating defendant can exert influence over the dominated director. Id. As Chief Executive Officer, Stephens has the ability to hire (and later fire) both Kramer and his air conditioning repair company. See, e.g., id. at \*9-10 (“As Meyerson is Telxon’s Chief Executive Officer he undoubtedly possesses the authority to hire and fire the corporation’s legal counsel”). Likewise, Stephens’ influence over Kramer as a result of Kramer’s personal sense of “owningness” exists without regard to Stephens’ shareholdings. Under these circumstances, plaintiffs have adequately pled that Kramer is both interested and lacks independence.

- Zuzolo: Non-party Zuzolo also rejected the First Place bid for personal reasons, rendering him interested. Like Kramer, he had an interest in continued receipt of board fees and the other emoluments of office. He was also a service provider to the Company. Zuzolo was a principal in a small law firm, which often provided legal services to First Niles and the Bank, a business relationship Zuzolo protected when he voted against the First Place merger (Compl. at ¶¶ 14, 56). Zuzolo was also Chief Executive Office and 100% shareholder of another one of the Bank’s vendors -- American Title (id. at ¶ 14). This small town title service provided title services in *almost all* of the Bank’s residential and commercial closings (id.). Zuzolo knew that First Place had its own title service company that competed with his American Title and that

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Stephens, defendants’ exclusive emphasis on this allegation alone ignores all of the other well-pled allegations of the Complaint.

rejection of the First Place offer insured that the Bank would continue to use the services of American Title (Compl. ¶ 56). Accordingly, Zuzolo acted to safeguard his own financial interests when he voted against the First Place merger, and his actions are entitled to no deference under the business judgment presumption.

Relying on Khanna, another Rule 23.1 case, defendants claim that because the Complaint does not state the exact dollar amount that Mr. Zuzolo's law firm or his title search company received from the Bank, it cannot state a claim (DOB at 14). Defendants are correct that the precise amount of profit made by American Title as a result of Bank work (facts which plaintiffs cannot know without the benefit of discovery) is not stated in the Complaint. The Complaint does, however, allege that the amount was substantial enough and the conflict sufficiently material that the OTS required disclosure of it to all Bank loan applicants (Compl. ¶ 14). Again, the kind of realism signaled by Rales makes it reasonable to infer that, *being the near-exclusive title services provider to a bank whose principal business consists of mortgage loans on residential properties -- which is one of the few banks in the community -- is a material business relationship to a small-town, sole proprietorship title company* (Compl. ¶¶ 7, 14). The threat of loss (which was a near certainty if the First Place bid was pursued) of this material business relationship rendered Zuzolo interested.

The possibility that Zuzolo's American Title would lose the Bank as a significant customer also indebted Zuzolo to Stephens, who as President and CEO, could cause the Bank to hire another title service company. Indeed, Delaware Courts have consistently found that similar vendor relationships render a director beholden to the person with the power to terminate such relationships. See In re Walt Disney Co. Deriv. Litig., 731 A.2d at 357-58 (holding, in the more stringent Rule 23.1 context, that a prominent architect, who was serving on

the Disney board, could not be independent in any transaction benefiting Eisner).<sup>11</sup> Thus, Zuzolo could not act independently of Stephens -- a conclusion that defendants do not even challenge.

- Eddy: Having already shown that the Complaint sufficiently pleads that a majority of the Board was incapable of exercising business judgment without outside influence, it is not necessary for plaintiffs to demonstrate that Eddy lacked independence or was tainted by self-interest. E.g., Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). Nevertheless, the Complaint adequately alleges conduct inconsistent with the proper exercise of business judgment from which it can be inferred that Eddy was beholden, and possessed a sense of “owingness,” to Stephens. Specifically, Eddy voted with defendant Stephens on *every* issue put before the Board during plaintiff Gantler’s tenure as a director (Compl. ¶ 10; see also id. ¶ 56). He also consented to false disclosures regarding Stephens’ compensation in the proxy statement filed in connection with the Company’s April 20, 2006 annual meeting (Compl. ¶ 10). These allegations create a reasonable inference that Eddy was not acting independently.

Defendants attempt to rebut this claim by improperly relying once again on cases applying the strict Rule 23.1 particularized pleading standard (DOB at 10) (quoting Khanna, 2006 WL 1388744, at \*15, in support of their claim that plaintiffs must “set forth the particularized facts”). Moreover, the teachings of the case defendants cite -- Khanna v. McMinn, 2006 WL 1388744 (Del. Ch.) -- actually support plaintiffs’ arguments. First, Khanna holds (as defendants acknowledge) that in certain circumstances a director’s voting pattern may be

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<sup>11</sup> See also In re Ply Gem, 2001 WL 755133, at \*8 (lawyer and consultants fees); See e.g., Orman, 794 A.2d at 31 (director is interested in fees generated by company that he wholly owns); In re New Valley, 2001 WL 50212, at \*7 (directors’ past receipt of \$30,000 to agree to serve as defendants’ nominee on another board rendered him beholden); Friedman, 1995 WL 716762, at \*5 (consultant fees); Steiner, 1995 WL 44199, at \*10 (Del. Ch.); Hamilton v. Nozko, 1994 WL 413299, at \*1 n.2 (attorney whose former firm rendered legal services for substantial fees to subject company lack independence).

“sufficient to negate a director’s presumed independence.” Id. at \*15 n.92. Such circumstances exist, according to Khanna, when the Complaint alleges facts beyond the challenged director’s voting record on the “few challenged transactions” so to show “a pattern of votes from which the Court can draw a reasonable inference” of acquiescence.” Id. at \*15.<sup>12</sup> Here, the Complaint meets this standard. Plaintiffs’ allegations are not limited to Eddy’s votes on the First Place bid and the Reclassification. Rather, the Complaint claims that Eddy voted with Stephens on *every vote over a three year period*.<sup>13</sup> Thus, the well-pled facts regarding Eddy’s actions, supported by the allegations with respect to his voting record, show actions inconsistent with an independence, denying him (and the Board) the protections of the business judgment rule presumption.

B. Count III – the Reclassification Claim.

Count III alleges that all defendants, either as officers or directors of First Niles, breached their fiduciary duties to plaintiffs by manipulating the Company’s corporate machinery for their personal advantage. Specifically, the Complaint claims that the Reclassification afforded defendants personal benefits not shared equally with, and achieved at the expense of, the unaffiliated shareholders. These advantages include, without limitation, increased liquidity

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<sup>12</sup> While defendants also fault plaintiffs’ Complaint for not explaining how Eddy’s alleged acquiescence benefits him (DOB at 10), the Khanna Court makes clear that such a showing is only necessary where the Complaint does not otherwise allege a pattern of voting behavior from which the Court could determine influence. 2006 WL 1388744, at \*15 (noting that the appropriate test is disjunctive).

<sup>13</sup> Moreover, the policy concern referenced both in Khanna and defendants’ brief (DOB at 10) is not present here, as Eddy’s votes were not the product of “routine consensus.” Significant dissent was voiced on some of the issues, but Eddy nevertheless blindly cast his vote with Stephens (*see, e.g.*, Compl. ¶ 54). Of course, one would not have known about this dissent merely by reviewing the preliminary proxy statement. That proxy statement failed to disclose that plaintiff Gantler opposed the Reclassification and falsely stated that, at the December 5, 2005 meeting, the board *unanimously* approved pursuing a stock reclassification rather than a cash-out merger (Compl. ¶ 79(a)). Defendants corrected this false disclosure, as well as many others, after plaintiff filed their initial complaint pointing out this proxy violation.

for defendants' First Niles stock. In contrast, the Reclassification deprived plaintiffs of a market for their First Niles stock (Compl. ¶ 94). Delaware courts have recognized that similar allegations state a claim for breach of fiduciary duty. Hamilton v. Nozko, 1994 WL 413299 (Del. Ch.).

To avoid this inescapable result, defendants try to recast the facts (which is obviously inappropriate on a motion to dismiss). They claim that the appropriate date to determine liability is December 5, 2005, when Stephens, Eddy, Kramer and Gantler comprised the First Niles Board (DOB at 16).<sup>14</sup> The Complaint clearly and accurately alleges that the newly constituted Board named above met twice in June 2006 to approve the resolutions

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<sup>14</sup> The decision made on December 5 was just to authorize the Company's lawyers to further investigate the reclassification option (Compl. ¶ 67 (quoting the minutes of the December 5 meeting minutes and alleging that, in the face of questions that the Powell Goldstein lawyers indicated would be addressed, the Board voted "to have Powell Goldstein LLP to go forward with a stock reclassification program in order to deregister from the SEC, and its requirements")). To the extent that the Court were to find that, contrary to the allegations of the Complaint, December 5 was the relevant date for determining liability, it is clear the actions of the Board members at the time (other than plaintiff Gantler who voted against) were not protected by the business judgment rule. The Complaint alleges that at the December 5 Board meeting, few details and no written plan were presented (Compl. ¶ 67). Plaintiff Gantler raised a number of legitimate concerns, such as the conflict of interest created by certain defendants ESOP holdings, all of which Powell Goldstein represented would be raised as part of the process. Approving and delegating all further decisions (such as the terms of the new preferred stock) with respect to a significant corporate transaction like the Reclassification -- as defendants would recast the facts -- based only on the cursory information and when there were material issues that remained unresolved, constitutes grossly negligent conduct and an improper delegation not protected by the business judgment rule. Aronson, 473 A.2d at 812 ("to invoke the [business judgment] rule's protection directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them"); see also In re Bally's Grand Derv. Litig., 1997 WL 305803, at \*4-5 (Del. Ch.) (directors are entitled to no protection under the business judgment rule where they "delegate duties which lie "at the heart of the management of the corporation"" or which "have the effect of removing from directors in a very substantial way their duty to use their own best judgment"" with respect to the "formal or informal plans for achievement"" of the company's long-term goals) (citations omitted).

necessary to implement the Reclassification from a Board prospective and to bring the Reclassification to a shareholder vote (Compl. ¶ 69). This Board determined that Reclassification was fair and urged shareholders to vote in favor of it (see supra, at 18-19). Despite defendants' attempts at revisionist history (which is at odds with their own Proxy's recitation of the events)<sup>15</sup> the latter Board is clearly implicated in the wrongdoing, making its members appropriate defendants. Likewise, the appropriate Board for this Court's loyalty analysis is the one that plaintiffs sued, a majority of which defendants do not even contest suffer from a disabling conflict.

Nor does the business judgment rule provide defendants any cover. At the time that First Niles adopted the Articles of Amendment that provide for the Reclassification, approved the terms of the Preferred Stock, determined that the Reclassification was fair and voted in favor of recommending the Reclassification to shareholders, the Board consisted of five members: defendants Stephens, Kramer, Eddy, Shaker and Csontos. A majority of these directors received material financial benefits from the Reclassification and/or are beholden to the self-interested Stephens.

- Stephens: Again, defendants do not, and cannot, contest Stephens' interest in the challenged decision. A man in his mid-70s, Stephens will enjoy increased liquidity in his First Niles stock not shared equally with the unaffiliated shareholders. Specifically, the Reclassification allows Stephens greater flexibility for share buy backs and affords him a fair value put right with respect to a substantial portion of his shares (see supra, at 19-21; Compl. ¶¶ 73-76).

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<sup>15</sup> See, e.g., Proxy at 5-6, 15, 17, 23-24, 30.

- Csontos: As with Stephens, defendants do not contest that Csontos, the Bank's compliance officer, was incapable of making a business judgment with respect to the Reclassification without extraneous influence. Csontos was a significant participant in the Company ESOP, which held *all* of his 12,456 First Niles shares (Compl ¶ 11). The put right triggered by delisting will provide him with greater liquidity than the unaffiliated shareholders (Compl. ¶¶ 75-76). Csontos also stands to receive greater liquidity through the possibility of share buybacks, which (as discussed above) the Company has a long history of pursuing. Finally, as the Bank's compliance officer, Csontos is beholden to his boss, Stephens. See supra, at 31 (collecting cases holding that officers are beholden to the persons who effect the terms of their employment).

- Kramer: Kramer is interested in the Reclassification and lacks independence from Stephens for many of the above-referenced reasons (supra, at 25-32). Specifically, he is a man of modest means who has benefited from the Company's stock buy back program in the past and can be expected -- in light of the Privatization Proposal's suggestions regarding the impetus of the Reclassification (Compl. ¶ 61) -- to continue to take advantage of these liquidation opportunities. His interest in possible employment with the Bank post-Reclassification further insures that he is obligated to, and lacks independence from, the interested Stephens.

- Eddy: As discussed above, the Complaint demonstrates, through, among other things, a pattern of votes drawn out over three years, that the facile Eddy acted in a manner indicative of domination by Stephens (see supra, at 34-35).

- Shaker: Shaker held a substantial amount of First Niles stock (Compl. ¶ 13). He stood to benefit from the increased liquidity that any stock buy back program would

afford him. Thus, Shaker suffered from a disabling conflict that rendered him interested in the Reclassification.

In the face of well-pled allegation that defendants “succumb[ed] to influences which convert an otherwise valid business decision into a faithless act.” Aronson, 473 A.2d at 816, defendants try to avoid liability claiming that a decision not to sell a company and instead reclassify a company’s stock cannot form the basis of a breach of fiduciary duty claim (DOB at 16-17). This is clearly contrary to Delaware law, which does not insulate faithless conduct from judicial scrutiny just because it involves a decision not to sell a company or a decision to reclassify a company’s stock.

Indeed, defendants’ exact argument was rejected by then-Vice Chancellor Jacobs in Hamilton v. Nozko, 1994 WL 413299 (Del. Ch.). There, like here, the Board caused the defendant corporation to delist from the NASDAQ, cease filing reports and providing public information under the Securities Exchange Act of 1934 (the “Exchange Act”) and terminate the Company’s SEC registration, limiting the stockholders’ ability to liquidate their investments. Id. at \*2. Defendants argued, on a Rule 12(b)(6) motion, that plaintiff’s claim was legally insufficient because defendants’ actions (i) did not constitute self-dealing since they affected all shareholders equally; and (ii) were protected by the business judgment rule because their sole purpose was to avoid the continuing expense and burden of complying with the Exchange Act’s reporting requirements. Id. at \*2. The Court rejected this argument. Applying the “doctrine that corporate action, even where legally permissible, will be proscribed if taken for an inequitable purpose,” the Court held that there is no blanket protection afforded to a decision to delist. Id. at \*6 (citing Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971)). Rather, “corporate fiduciaries commit an actionable breach of fiduciary duty” when, as here, “they cause the

corporation's stock to be deregistered and delisted and as a result, cause the market for the stockholders' investment to become impaired or eliminated" for "self-interested reasons." Id.; see also Seagraves v. Urstadt Prop. Co., Inc., 1989 WL 137918, at \*4 (Del. Ch.) (complaint alleging that directors caused company to delist for an improper purpose stated a claim); Berger v. Scharf, 816 N.Y.S.2d 693 (N.Y. App. Div. 2006) (complaint alleging that defendants breached their fiduciary duties in connection with delisting stated claim).

II. COUNTS I AND III STATE A CLAIM AGAINST CSONTOS AND SAFAREK, OFFICERS WHO PARTICIPATED IN THE ALLEGED WRONGS, AND COUNT III STATES A CLAIM AGAINST SHAKER, A DIRECTOR WHO PARTICIPATED IN THE ALLEGED WRONGS.

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Relying again on their own revisionist view of history, defendants argue that the "claims for breach of fiduciary duty arising from the decision not to sell First Niles and in favor of the Reclassification should be dismissed against Messrs. Safarek, Csontos, and Shaker because none of them were members of the Board at the time of the votes on the questioned transactions and did not cast a vote regarding those transactions" (DOB at 20). Defendants' myopic and vote-centered argument is at odds with both established Delaware law and the well-pled facts of the Complaint (as well as defendants' own recitation of the events in their Proxy). Defendants ignore that Safarek and Csontos were *officers* at the time that they sabotaged the sale process and proposed that the Board adopt the Reclassification plan. Delaware law has always held that officers, as well as directors, owe fiduciary duties to a corporation and its stockholders. In re Walt Disney Co., 2004 WL 2050138, at \*3 (Del. Ch.) ("with respect to the obligation of officers to their own corporation and its stockholders, there is nothing in any Delaware case which suggests that the fiduciary duty owed is different in the slightest from that owed by directors") (citation omitted). Likewise, defendants ignore the allegations of the Complaint that make clear that Csontos and Shaker participated in the Board decision to approve the

Reclassification by voting in favor of the implementing Articles, adopting the changes to the Preferred Stock and recommending that shareholders vote in favor (an action in which Safarek also joined) (Compl. ¶¶ 69, 89 and p. 25; see also supra, at 18-19).

III. COUNT II STATES A CLAIM FOR BREACH OF FIDUCIARY DUTY BASED ON THE MATERIAL OMISSIONS AND MISSTATEMENTS IN THE PROXY.

Defendants “are under a fiduciary duty to disclose fully and fairly all material information within” their control when they seek shareholder action. Arnold v. Society for Sav. Bancorp., Inc., 650 A.2d 1270, 1277 (Del. 1994). An omitted fact is material if “there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.” Id. This standard does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused a reasonable investor to change his vote, just that it would have “altered the ‘total mix’ of information made available.” Id. (citations omitted). Because a determination of materiality depends upon an assessment of the inferences a reasonable stockholder would draw and the significance of those inferences to an individual stockholder, the determination of whether a board’s disclosures are adequate in a given case cannot ordinarily be resolved on a Rule 12(b)(6) motion. Lewis v. Vogelstein, 699 A.2d 327, 333 (Del. Ch. 1997) (“generally the materiality of ‘facts’ omitted from a proxy statement is a question of fact unsuitable for determination on a motion to dismiss . . .”); see also McMullin v. Beran, 765 A.2d 910, 926 (Del. 2000) (reversing lower court’s Rule 12(b)(6) dismissal because disclosure issues alleged required court to “decide a mixed question of law and fact” for which a complete factual record was necessary). Here, the Complaint alleges that the Proxy contains material omissions and misstatements, making dismissal of plaintiffs’ disclosure claims inappropriate.

- Disclosures regarding the sale process: Plaintiffs contend that the Proxy’s lengthy discussion of the failed sale process is misleading in at least two material respects. First,

it omits any of the history with respect to due diligence, which would have provided shareholders with an understanding as to why only one value-maximizing bid materialized (Compl. ¶ 82(b); see also id. at ¶¶ 39-47). Conceding that this information is not included in the Proxy, Defendants argue that they face no liability for this omission as a result of the self-flagellation doctrine (DOB at 25). Defendants' reliance on that doctrine is misplaced. The self-flagellation doctrine only shields defendants from any obligation to disclose conclusions implicating themselves in a breach of fiduciary duty; it does not obviate the duty to disclose material *facts*. See generally In re MONY Group Inc. S'holders Litig., 852 A.2d 9, 27 (Del. Ch. 2004). Here, plaintiffs challenge the omission of any of the true *facts* regarding how the Cortland bid was handled (and not the conclusions that flow therefrom), allegations that Delaware courts have consistently found to state a claim. See, e.g., McMullin, 765 A.2d at 925 (reversing Rule 12(b)(6) dismissal where plaintiff alleged that the tender offer documents failed to disclose information regarding the handling of potential offers); Clements v. Rogers, 790 A.2d 1222, 1243 (Del. Ch.) (2001) (when a proxy statement details the sale process, it must do so in a fair and balanced manner that does not create a misleading impression of how sale process operated in fact).<sup>16</sup>

Second, the Proxy fails to identify plaintiff Gantler as the dissenting director and indicate the reasons -- which were known to the Board -- for his dissent, as required by SEC Regulation M-A (Compl. ¶ 82(a); see also 17 C.F.R. § 229.1014(a) ("If any director dissented or abstained from voting on the Rule 13e-3 transaction, identify the director, and indicate, if known, after making reasonable inquiry, the reasons for the dissent or abstention.")). Defendants do not

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<sup>16</sup> Moreover, having undertaken to disclose the existence of the Cortland bid, defendants were duty bound to "provide the stockholders with an accurate full, and fair characterization of those historic events." See Arnold, 650 A.2d at 1280.

contest that this information is material and should be disclosed (DOB at 23-24).<sup>17</sup> Rather, they cite the description of this litigation and falsely claim that the reason for Mr. Gantler's objections were included in the Proxy (*id.* at 23 (quoting Proxy at 43)). *The cited passage does not, however, state any of the reasons for Mr. Gantler's dissent.* It does not even mention that plaintiff Gantler was at some point a director, let alone identify him as the director who dissented.<sup>18</sup> Defendants next contend, relying on Fisher v. United Technologies Corp., 1981 WL 7615 (Del. Ch.), that disclosing the fact of the litigation is sufficient (DOB at 24). Plaintiffs do not, however, challenge the quality of disclosures regarding this litigation. But such disclosures, which are buried at the end of the Proxy and do not identify plaintiff Gantler as a member of the Board, are no substitute for adequate disclosure of the Board's deliberations. Accordingly, the reasons for Mr. Gantler's dissent were not, and should be, disclosed.

Plaintiffs' next claim -- that the Proxy falsely states that the Board rejected the First Place bid "after careful deliberations" when in reality, there were no discussions or deliberations regarding the First Place bid at the March 9 meeting at which it was rejected -- is virtually ignored by defendants. (Compl. ¶ 82(c); see also id. at ¶ 54 (reciting that the vote on the First Place Definitive Merger Proposal was called without any discussion or deliberation whatsoever)). Defendants only half-heartedly challenge the materiality of this misstatement,

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<sup>17</sup> This is especially so in light of defendants' disclosure of the rest of the Board's reasons for favoring such a transaction at that point in time (Proxy at 15-16).

<sup>18</sup> Defendants further wrongfully claim that they have no duty to identify Mr. Gantler by name as the dissenting director (DOB at 24). The Proxy discloses that the Board voted unanimously in June 2006 to approve the Articles of Amendment to effectuate the Reclassification without disclosing that the dissenting director from the December 2005 vote had been replaced and, in fact, is the same individual now pursuing a lawsuit against the directors for their actions in approving the Reclassification (see Proxy at 15, 43). This is misleading, making identification of Mr. Gantler as the dissenting director material information.

claiming that they had no duty to disclose all the details of their deliberations or the “corporation’s inner workings and its day-to-day functioning” (DOB at 25-26) (quoting Loudon v. Archer-Daniels-Midland Co., 700 A.2d 135, 144 (Del. 1997)). But having chosen to characterize the Board’s deliberations, defendants have an obligation to do so fully and truthfully. In re Tele-Communications, Inc. S’holders Litig., 2005 WL 3642727 (Del. Ch.) (finding that defendants’ statement in the proxy that board gave “careful consideration” to premium to be paid to shareholders in approving transaction would be material if false and denying defendants’ motion for summary).

- Disclosures Regarding the Effect of the Reclassification: The Complaint next alleges that, while the Proxy includes a generally detailed discussion of the Reclassification’s effects, it omits two key facts regarding future liquidity and information flow to shareholders. First, the Proxy fails to disclose that the Reclassification renders any future acquisition of the Company less likely (Compl. ¶ 82(d)). This omission that is made material by defendants’ disclosure that “termination of our status as an SEC-registered Company will not have significant impact on any future efforts by the Company to raise additional capital or to acquire other business entities.” (Proxy at 12; see also Compl. ¶ 82(d)). Defendants ignore the context of this disclosure, responding only that it is speculative (DOB at 26). The effects of the Reclassification on First Niles as an acquisition target are no more speculative than effects of the Reclassification on First Niles as a bidder, both of which are subject to verification through expert testimony.<sup>19</sup> Having disclosed the latter, defendants had an obligation to disclose the

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<sup>19</sup> Indeed, defendants’ lawyers acknowledge, in the articles that they have authored and that defendants improperly submit as part of their outside-of-the-record antidotal evidence (DOB at 17-18 & Ex. C), that “by deregistering, a company limits its access to capital markets . . . . Similarly, it will not be able to offer liquid stock in an acquisition . . . .”

former, especially given the liquidity concerns implicated by the Reclassification. See Arnold, 650 A.2d at 1290.

Second, the Complaint further alleges facts from which it is reasonable to conclude that defendants, as a part of their overall deregistration scheme, intend to surrender the Bank's federal charter and reincorporate the Company in a state other than Delaware (see, e.g., Compl. ¶¶ 29, 36, 62-63). Yet, defendants omit these facts from the Proxy (Compl. ¶ 82(e)). These omissions are material given the information vacuum created by termination of the Company's SEC reporting obligations and particularly misleading given defendants' claim in the Proxy that this information vacuum will be mitigated by the availability of quarterly reports that the Bank is required to file as a federally chartered thrift (see e.g., Proxy at 11). In response, defendants once again claim speculation (DOB at 26). But defendants' argument confuses the standards for speculative disclosure with the standards on a motion to dismiss. There is nothing inherently speculative about plaintiffs' claim regarding the defederalization, an event purely within defendants' control. Compare Orman, 794 A.2d at 36 (effects on Company's financial prospects of any lifting of the Cuban embargo, an event outside of the defendants' control, did not have to be disclosed because the possibility of the long-time ban on Cuban trade being lifted was purely speculative). Plaintiff's allegations just have not yet been proven. If defendants do intend to surrender the Bank's federal charter, an inference supported by the well-pled allegations of the Complaint, defendants have an obligation to disclose this material fact.

- Disclosures Regarding The Impetus for the Reclassification: Next plaintiffs allege that although the Proxy includes prolix detail regarding the Board's reasons for

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Mark R. Baran and Katherine M. Koops, Escaping SOX, COMMUNITY BANKING (May 2005) at p. 22.

endorsing the Reclassification, it omits at least two critical self-interested rationales (thereby obscuring the personal advantages that defendants will receive as a result of the transaction) and misrepresents at least one other reason for the Reclassification. First, the Proxy fails to disclose that defendants endorsed the Reclassification because -- unlike other options facing the Company -- it allowed greater flexibility to effectuate negotiated buybacks of each others' stock (Compl. ¶ 82(g) & (h)). This allegation is fully supported by the Privatization Proposal submitted to the Board by management (Compl. ¶¶ 61, 74), is material and should be disclosed. See Clements, 790 A.2d at 1243 n.60 (defendants have a duty to disclose all facts regarding their motives if they are relevant to the decision to be made).

Defendants do not deny that this information was omitted or that information regarding defendants' undisclosed conflicts is generally material. Rather, they once again try to rely on Nebenzahl to argue that the possibility for such future buy backs creates no self-interest (DOB at 29). As discussed above (supra, at 26-27), this argument is misplaced. Moreover, even assuming that defendants are correct and the buy backs create no incentive for the defendants to favor the Reclassification that is not shared equally with the shareholders, defendants lack of self-interest in the share buy backs does not cure the disclosure issue. Delaware courts have made clear that when directors "choose to state their reasons for recommending an action . . . that statement must be true and not misleading." In re MONY Group Inc. S'holders Litig., 853 A.2d 661 (Del. Ch. 2004). Here, by not enumerating increased flexibility for share buy backs among their list of reasons for the Reclassification, defendants violated this rule. See also Matador Capital Mgt. Corp. v. BRC Holdings, Inc., 729 A.2d 280, 296 (Del. Ch. 1998) (requiring supplemental disclosures where lists of reasons for transaction was not complete and stating "where, as is true here, a board 'does undertake to formulate and disclose a statement of reasons

for its recommendation, shareholders can be expected to put some weight on it” and it must be accurate) (citation omitted); In re Pure Resources, Inc. S’holders Litig., 808 A.2d 421, 452 (Del. Ch. 2002) (in order for “key factors” section detailing defendants’ reasons for tender offer not to be misleading, defendants were required to state motivating factors for offer).

Finally, defendants also falsely represented the effect of the Reclassification on ESOP participants, including the likelihood that defendants Stephens, Csontos and Safarek will achieve increased liquidity, by wrongfully claiming that the put and appraisal rights held by these defendants will only be exercisable if the Company is unable to list its stock on either the OTB or the pink sheets. (Compl. ¶ 82(i); see also Proxy at 22).<sup>20</sup> In reality, the put and appraisal rights will be triggered even if First Niles stock is traded on these platforms and under all of the scenarios that the Board envisioned when it asked shareholders to approve the Ratification.

Defendants do not deny the materiality of this omission but rather challenge this conclusion as a matter of law (DOB at 30). They rely on an IRS Private Letter Ruling 95-29-043 (Oct. 30, 1995), which they characterize as the “only available guidance” on the definition of “readily tradable” (DOB at 30). But that private letter ruling specifically declines to rule on the issue finding only that stock traded on the NASDAQ Small Cap Market (where First Niles shares were traded prior to the Reclassification) are readily tradable on the established market. Id. at 3 (“Because ruling requests (2) [whether the Common Stock at issue is considered “readily tradable on an established securities market”] and (3) above involve issues that are properly addressed by the Key District Officers, we decline to rule on these two ruling requests.”). In

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<sup>20</sup> Defendants’ claim that the “possibility that the management defendants would receive a put right as a result of the Reclassification is fully disclosed” mischaracterizes the Proxy (DOB at 30-31) (citing Proxy at 22). The Proxy clearly recites that the put right will only be triggered in the event that the Company is “not able to list our common stock with either” the OTC bulletin board or the pink sheets (id.).

contrast, IRS authorities that do provide relevant guidance find that stocks trading on the OTB (and by extension, the pink sheets) are not readily tradable on an established securities market.<sup>21</sup> See IRS Private Letter Ruling 114782-99 (Sept. 27, 2000) (“Since the OTCBB does not offer investors comparable standards and protections, a security that is quoted on the OTCBB will not be considered ‘publicly traded’ and, therefore, not “readily tradable on an established securities market”) (Ex. A hereto). Thus, plaintiffs’ claim that the Proxy misstates the effect the Reclassification on ESOP participants is accurate and Shareholders are entitled to the truth.

IV. SHAREHOLDER APPROVAL CANNOT INSULATE THE DEFENDANTS FROM LIABILITY FOR COUNT III, GIVEN THE LACK OF COMPLETE DISCLOSURE.

Defendants argue that shareholder approval for the Reclassification provides an independent reason to apply the protections of the business judgment rule (DOB at 19-20). For defendants to “access the safe harbor of ratification,” however, “they must meet an affirmative ‘burden of demonstrating full and fair disclosure.’” Sample v. Morgan, 914 A.2d 647, 665 (Del. Ch. 2007) (citation omitted). As discussed above, the Complaint pleads that defendants omitted material information and made material misrepresentations in the Proxy. Indeed, defendants admit that certain information is missing (but claim there is no duty for them to disclose their own wrongdoing). Given these omissions and misstatements, defendants cannot find any cover in the shareholders’ misinformed vote in favor of the Reclassification. Id.; see also Clements, 790 A.2d at 1243 n.62 (defendants’ reliance on the doctrine of self-flagellation may exonerate

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<sup>21</sup> Any uncertainty regarding the availability of the put right can be expected to be resolved in favor of exercise. It is unlikely that the Company would subject itself to potential liability from any ESOP participant.

defendants from disclosure liability but will also preclude any acquiescence or ratification defense) (citing Brown v. Perrette, 1999 WL 342340 (Del. Ch.)).<sup>22</sup>

V. THIS COURT HAS JURISDICTION OVER DEFENDANTS CSONTOS AND SHAKER, DIRECTORS OF A DELAWARE CORPORATION ALLEGED TO HAVE VIOLATED THEIR FIDUCIARY DUTIES, PURSUANT TO 10 DEL. C. § 3114.

Defendants' final argument relies on their revisionist reading of the Complaint to claim that because Csontos and Shaker were not involved in the Reclassification vote, they are not subject to jurisdiction. As discussed above, the Complaint clearly implicates both Csontos and Shaker, directors of a Delaware corporation, in the Reclassification approval process. Having served as directors of a Delaware corporation, accepted the concomitant fiduciary obligations of those positions and consented to personal jurisdiction in Delaware, this Court can properly exercise jurisdiction over Csontos and Shaker, pursuant to 10 Del. C. § 3114.

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<sup>22</sup> Defendants' ratification claim relates only to Count III. They do not (and cannot) defend the sale claim (Count I) on this ground, as defendants did not afford the shareholders any vote on these issues.

CONCLUSION

For the reasons set forth herein, plaintiffs respectfully request that defendants' motion to dismiss be denied in all respects.

ROSENTHAL, MONHAIT & GODDESS, P.A.



Norman M. Monhait (Del. Bar. No. 1040)  
Jessica Zeldin (Del. Bar No. 3558)  
919 North Market Street, Suite 1401  
Wilmington, Delaware 19899-1070  
(302) 656-4433  
Attorneys for Plaintiffs

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