IN THE COURT OF COMMON PLEAS
CUYAHOGA COUNTY, OHIO

FRANKLIN, PLOTNICK & CARL, INC. PROFIT SHARING PLAN, derivatively on behalf of EATON CORPORATION	)	**CASE NO. CV 11 748467**
	)	**JUDGE JOHN P. O'DONNELL**
Plaintiff,	)	
v.	)	
MICHAEL J. CRITELLI, *et al.*	)	**JOURNAL ENTRY**
Defendants.	)	

John P. O'Donnell, J.:

STATEMENT OF THE CASE

Plaintiff Franklin, Plotnick & Carl, Inc. Profit Sharing Plan filed a first amended verified shareholder derivative complaint on June 1, 2011. On July 15, the defendants filed a motion to dismiss the first amended complaint. The basis of the motion is that the plaintiff did not make a pre-suit demand upon nominal defendant Eaton Corporation's board to pursue its claims in accordance with Rule 23.1 of the Ohio Rules of Civil Procedure. The plaintiff opposed the motion by a brief filed August 31. Other filings connected to the motion include: the plaintiff's September 22 notice of supplemental authority; the defendants' September 23 reply in support of the motion and September 26 response to the supplemental authority; the defendants' December 1 notice of supplemental authority and February 16, 2012 second notice of supplemental authority; the plaintiff's February 22 response to the second notice of supplemental authority and May 7 and May 25 notices of supplemental materials; the defendants' August 13 notice of additional supplemental authority, with the plaintiff's August

23 response, the defendants' September 10 reply to the response and the plaintiff's September 20 surreply; and the defendants' October 29 notice of additional supplemental authority with the plaintiff's November 8 response. The court also heard oral arguments on February 2, 2012. The court has considered all of that evidence, authority and argument – except the evidence attached to the plaintiff's May 7 and May 25 notices of supplemental materials, since those filings contain matters outside the pleadings that cannot be considered on a motion to dismiss – and this entry follows.

STATEMENT OF FACTS[1]

Factual allegations of the first amended complaint

Franklin, Plotnick & Carl, Inc. Profit Sharing Plan owns 300 shares of nominal defendant Eaton Corporation's stock. Franklin, Plotnick has been a shareholder since at least 2004. Eaton is an Ohio corporation in the business of designing, making and selling hydraulic equipment for use in airplanes. Twelve of the defendants are current or former members of Eaton's 11-member board of directors[2]; four of them are officers or in-house counsel.[3]

In 2002, six employees left Eaton to work with competitor Frisby Aerospace. Those employees misappropriated Eaton's trade secrets in the form of thousands of pages of documents containing proprietary information relating to hydraulic pumps, motors and other Eaton products. Eaton discovered the misappropriation and on July 9, 2004, filed a lawsuit in Hinds County, Mississippi, against Frisby, Frisby's president, and the former Eaton employees working as engineers at Frisby. The lawsuit alleged theft of trade secrets and conspiracy. The

[1] The court's recitation of the facts includes verbatim allegations from the first amended complaint, reasonable paraphrases of those allegations, and, where indicated, reasonable inferences from those allegations.
[2] The director defendants are Michael Critelli, Alexander Cutler, Ernie Green, Ned Lautenbach, Deborah McCoy, John Miller, Gregory Page, Charles Golden, Victor Pelson, Gary Tooker, Arthur Johnson and Todd Bluedorn.
[3] Director defendant Cutler is also the company's chief executive officer. The other officer defendants are Vic Leo, Mark McGuire and Taras Szmagala.

case was presided over by Judge Bobby B. DeLaughter. At the time, Eaton estimated its annual sales volume attributable to the implicated products at about $150 million and valued the stolen intellectual property at over $200 million. The total value of the lost trade secrets was estimated to be near $1 billion.

One of Eaton's witnesses against Frisby was Milan Georgeff. Georgeff is a former Frisby employee who, after being fired by Frisby, told Eaton about the misappropriation of its trade secrets. In exchange for Georgeff's testimony and assistance in gathering evidence, Eaton promised to pay any expense that he might incur, including expenses to defend Georgeff against eventual criminal or civil litigation. Eaton also guaranteed Georgeff employment as an engineer in the field of aeronautical hydraulics through at least age 65 if he lost his job because of his participation in the lawsuit against Frisby. The contract with Georgeff is in writing and was known to all of Eaton's directors.

Judge DeLaughter appointed Jack Dunbar, Esq., as a special master to administer the heavy volume of discovery in the trade secret lawsuit. Part of the discovery sought by Frisby was evidence of any arrangements or understandings between Eaton and Georgeff. Eaton denied having any compensation agreement with Georgeff and Eaton did not produce its contract with Georgeff or otherwise indicate that a contract existed. In the meantime, through discovery in Georgeff's own lawsuit against Frisby, Frisby obtained a copy of the Eaton-Georgeff agreement.

Frisby then moved to dismiss the trade secret lawsuit as a sanction for Eaton's intentional concealment in discovery of its illegal financial arrangement with Georgeff. The board of directors was aware of Frisby's motion to dismiss and the reasons for it.

Judge DeLaughter referred proceedings on the motion to dismiss to Dunbar, the special master. The special master concluded that Eaton had violated the rules of discovery and recommended additional investigation to determine whether the violations were intentional and whose fault they were. Dunbar's recommendation was approved by Judge DeLaughter on July 24, 2006. All of the defendants here were aware of the special master's findings and the court's order: the officer defendants by virtue of having participated in the discovery violations and the director defendants by having been informed by management of the progress of the trade secret lawsuit.

The special master's investigation of the discovery violations proceeded and included the depositions of several Eaton lawyers. In late 2006, the special master issued another report and recommendation that included a finding that Eaton's discovery answers were "truly false" in an "intentional effort to mislead." That report and recommendation was known to all director defendants.

Around the time of the special master's report concluding that Eaton had intentionally withheld evidence in discovery, Eaton retained Mississippi attorney Ed Peters as counsel in the trade secret lawsuit. However, Peters never formally entered a written appearance as counsel in the trade secret lawsuit; his involvement apparently became known only when he accidentally sent an email meant for somebody else to Frisby's counsel.

Peters and Judge DeLaughter had a long relationship beginning when Peters was a Hinds County district attorney and DeLaughter one of his assistant prosecutors. Judge DeLaughter and Peters were known to be close friends and Eaton hired Peters for that reason, believing Peters would be able to influence Judge DeLaughter's decisions. All of the defendants knew that Peters was retained for that purpose.

Between the time of the special master's report and recommendation in early December, 2006, and a ruling by the court on April 6, 2007, Peters engaged in improper *ex parte* discussions with Judge DeLaughter.

On April 6, 2007, Judge DeLaughter issued an opinion rejecting the majority of the special master's findings of wrongdoing by Eaton and denying Frisby's motion to dismiss the trade secret lawsuit.

In the meantime, discovery depositions of the former Eaton engineer defendants in the trade secret lawsuit had been stayed because they were defendants in a separate criminal proceeding. However, on June 4, 2007, Judge DeLaughter dissolved the stay and denied the defendants' motion for a continued stay until the conclusion of the criminal case. Dunbar recommended that the affected defendants not be deposed until after the criminal trial, which was set to take place before the discovery deadline in the civil suit. Judge DeLaughter rejected that recommendation, thereby requiring the Frisby defendants to either testify or decline to testify by invoking their Fifth Amendment privilege against self-incrimination. Judge DeLaughter's decision favored Eaton by creating a quandary for the engineers: testify and expose themselves in the criminal case, or not testify and expose themselves to a negative inference in the trade secret lawsuit.

That decision was appealed to the Mississippi Supreme Court, which granted a temporary stay of the engineers' depositions. After that stay expired, the presiding judge in the criminal lawsuit in federal court conferred with Judge DeLaughter, who consented to postponing the depositions, but then reversed course once the criminal case was continued.

About this same time – the fall of 2007 – Judge DeLaughter overruled other recommendations by Dunbar that Eaton considered unfavorable. On October 25, 2007, Peters called Larry Latham, a local lawyer, and asked if Latham would be willing to serve as special master to replace Dunbar. Four days later, Judge DeLaughter *sua sponte* removed Dunbar as special master and appointed Latham.

In December, 2007, it became publicly known that Judge DeLaughter was being investigated for bribery involving Ed Peters. Because of that, Judge DeLaughter disqualified himself from the trade secret lawsuit on January 4, 2008.

Three days later, Joseph C. Langston, another Mississippi lawyer, admitted by pleading guilty in a criminal case against him that in December 2005 he delivered $50,000 in cash to Ed Peters in order to influence Judge DeLaughter in another case. Langston's guilty plea and other information from that case made Frisby realize that Peters might have improperly influenced Judge DeLaughter in the trade secret lawsuit. Frisby then filed a motion to stay discovery pending review for impropriety of Judge DeLaughter's rulings. Around the same time, the new special master, Latham, resigned. Finally, it was publicly reported on January 28, 2008, that the Federal Bureau of Investigation was investigating whether there were improper contacts between Peters and Judge DeLaughter in the Eaton trade secret case. According to the first amended complaint in this lawsuit:

> By this date, there could be no reasonable doubt within the Eaton boardroom that Peters, while working on behalf of Eaton, had improper and likely unlawful contacts with Judge DeLaughter. It was known that Peters had improperly influenced Judge DeLaughter in at least one other case. It was known that Peters's involvement in the litigation on behalf of Eaton was withheld from Frisby. It was known that Eaton had improperly compensated a fact witness and had lied about it to the court.

Eventually, Peters and Judge DeLaughter were criminally prosecuted for their conduct in the trade secret lawsuit. Ultimately, on December 22, 2010, the new judge in the trade secret lawsuit sanctioned Eaton in the amount of about $1,560,000 for its discovery violations, and then dismissed the entire lawsuit with prejudice, finding that "the shocking facts of Peters's *ex parte* with Judge DeLaughter, the clear knowledge by Eaton, as shown, with 'red flags' being raised, Eaton's failure to take any corrective action and, instead, 'looking away,' require that this court 'protect the integrity of the court and the judicial process' by imposing the most severe sanction available: dismissal with prejudice of all of the plaintiff's claims against the defendants."

Franklin, Plotnick's derivative causes of action

The plaintiff's first cause of action is a breach of fiduciary duty. By this claim, the plaintiff alleges that the director defendants breached their duty of care to Eaton and its shareholders by participating in the misconduct in the Mississippi litigation or by consciously ignoring "all the red flags of which they were or should have been aware." By breaching this duty, the director defendants damaged the corporation by forfeiting the opportunity to prevail in the trade secret lawsuit and exposing Eaton to subsequent antitrust lawsuits by Frisby and its successor.

By its second cause of action, the plaintiff claims that the same alleged misconduct constitutes a breach by the director defendants of their duty of loyalty, which requires that they act in the best interest of the company.

The third and fourth causes of action are against the officer defendants and are separate claims for breach of fiduciary duty (third claim) and breach of the duty of loyalty (fourth claim).

The fifth cause of action is captioned as "waste of corporate assets" and is asserted against all defendants. By this claim, the plaintiff claims that "by failing to prevent or stop the wrongful conduct, defendants undertook actions that lacked corporate purpose and have caused the company to waste valuable corporate assets."

Demand futility allegations

The plaintiff concedes it has not made a demand on the board of directors, pursuant to Civil Rule 23.1, to authorize a lawsuit on behalf of the corporation for the same claims made in the first amended complaint. By way of excusing that demand, the plaintiff alleges that "such a demand would be futile because the director defendants face a substantial likelihood of personal liability that would require that they file a lawsuit against themselves for substantial damages."

LAW AND ANALYSIS

The management of a corporation is properly exercised by its board of directors and officers, not its shareholders. Whether to bring a lawsuit on behalf of the corporation is a management decision, even if the lawsuit's causes of action cast the company's directors or officers as defendants. It is a basic principle of corporate governance that the decisions of a corporation—including the decision to initiate litigation—should be made by the board of directors or the majority of shareholders. *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 530 (1984). An exception to this general rule is the shareholder's derivative lawsuit: a case brought by a shareholder to assert a corporate claim.

The derivative form of action permits an individual shareholder to bring suit to enforce a corporate cause of action against officers, directors and third parties. *Ross v. Bernhard*, 396 U.S. 531, 534 (1970). Devised as a suit in equity, the purpose of the derivative action is to place in the hands of the individual shareholder a means to protect the interests of the corporation from the misfeasance and malfeasance of faithless directors and managers. *Cohen v. Beneficial Loan Corp.*, 337 U.S. 541, 548 (1949).

But because the shareholder, by filing a lawsuit, usurps the normal authority of the board of directors, the law requires a plaintiff in a shareholder derivative lawsuit to justify that usurpation. In particular, Civil Rule 23.1 provides, in pertinent part:

> In a derivative action . . . [t]he complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors and, if necessary, from the shareholders and the reasons for his failure to obtain the action or for not making the effort. . .

The demand requirement is essentially a requirement that the shareholder exhaust his or her intracorporate remedies before going to court with a derivative suit. *Carlson v. Rabkin*, 152 Ohio App.3d 672, 2003-Ohio-2071, ¶15 (1st Dist.). The corporation's management must be given the first opportunity to institute the litigation since, as a general principle, the responsibility for determining whether a corporation should use the courts to enforce a cause of action is, like other business questions, ordinarily a matter of internal management left to the discretion of the directors. *Id.*

In Ohio, Civil Rule 23.1 explicitly excuses the need for a demand where it would be futile. Courts have said that futility in this context means that the directors' minds are closed to argument and that they cannot properly exercise their business judgment in determining whether the suit should be filed. *Drage v. Procter & Gamble*, 119 Ohio App.3d 19, 25 (1st Dist. 1997). Additionally, a pre-suit demand is presumptively futile where the directors are antagonistic, adversely interested, or involved in the transactions attacked. *Bonacci v. Ohio Highway Express, Inc.*, 8th Dist. No. 60825, 1992 Ohio App. LEXIS 3940, at 9 (July 30, 1992). Demand may also be excused when all directors are named as wrongdoers and defendants in a suit. *Carlson*, supra, at 681. But no matter why a plaintiff claims that a demand would be futile, an allegation of demand futility must be supported by sufficiently particular facts to allow a court to evaluate the claim. As with any motion to dismiss made under Civil Rule

12(B)(6), the court must assume that all factual allegations in the amended complaint are true. *Barr v. Lauer*, 8th Dist. No. 87514, 2007-Ohio-156, ¶5.

Two tests have been developed to gauge a plaintiff's claim of demand futility, depending on whether the plaintiff's substantive claims involve allegations of conscious decision-making – even if the decision was *not* to undertake a particular action – or the absence of a decision by the board of directors.

Where a board has made a conscious decision, the *Aronson* test is used: whether, under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent or (2) the challenged transaction was otherwise the product of a valid exercise of business judgment. *Aronson v. Lewis*, Del. Supr., 473 A.2d 805, 814 (1984).

But where the board has not engaged in a "challenged transaction" so that the subject of the derivative suit is not a business decision of the board, the *Rales* test applies. Under that test, a court must determine whether or not the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand. *Rales v. Blasband*, Del. Supr., 634 A.2d 927, 934 (1993).[4]

The plaintiff argues that the *Aronson* test should be applied here because the amended complaint alleges a "decision to take no action"[5] to stem the illegal conduct in the trade secret lawsuit despite the directors' knowledge of the conduct. In other words, as asserted in the

[4] Although both of these tests are creations of the Delaware Supreme Court they are indistinguishable from Ohio's substantive law and have been applied regularly in the courts of Ohio. See, e.g., *In re Keithley Instruments, Inc*., 599 F. Supp. 2d 875, 888, at footnote 10: The Court perceives no substantive difference between Ohio and Delaware law on this issue, and Ohio courts routinely look to Delaware case law for guidance in deciding corporate law issues generally, and demand futility issues specifically.
[5] Brief in opposition to the motion to dismiss, page 8.

amended complaint, the directors "ignored all the red flags"[6] alerting them to wrongdoing and the decision to ignore them was "not the product of any valid exercise of business judgment."[7] Since the theory of recovery is dictated by the plaintiff's allegations, and the plaintiff believes it can prove that the directors consciously chose to ignore conduct that was damaging to the corporation, then the court will apply the *Aronson* test.

Under the first part of the *Aronson* formulation, a pre-suit demand is excused as futile where the plaintiff can show a reasonable doubt that the directors are disinterested. The plaintiff asserts that there is a reasonable doubt that the director defendants are disinterested, and therefore demand would be futile, because the director defendants all "face a substantial likelihood of personal liability."[8] Consideration of this argument requires an evaluation of the elements the plaintiff will have to prove to recover on its claims against the directors for breach of fiduciary duty.

Section 1701.59(B) of the Ohio Revised Code requires a corporation's director to perform his duties "in good faith, in a manner the director reasonably believes to be in or not opposed to the best interests of the corporation, and with the care that an ordinarily prudent person in a like position would use under similar circumstances." R.C. 1701.59(E) sets forth the circumstances under which a director can be found to have violated that duty as follows:

> A director shall be liable in damages for any action that the director takes or fails to take as a director only if it is proved by clear and convincing evidence in a court of competent jurisdiction that the director's action or failure to act involved an act or omission undertaken with deliberate intent to cause injury to the corporation or undertaken with reckless disregard for the best interests of the corporation.

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[6] Amended complaint, ¶¶152 and 158.
[7] Id., ¶139.
[8] Am. complaint, ¶138.

This is essentially a codification of the common law business judgment rule, which immunizes directors' decisions from judicial review except in cases of fraud, bad faith or abuse of discretion. *Koos v. Central Ohio Cellular*, 94 Ohio App. 3d 579, 589 (8th Dist. 1994).

The allegations in the amended complaint – which, it is worth repeating, the court at this stage is required to accept as true – include an allegation that the board has an audit committee that is responsible for retaining outside counsel and approving their fees, overseeing litigation and reporting developments in material litigation to the full board.

The plaintiff further alleges that every member of the board: knew about Frisby's theft of the trade secrets, and that their value to Eaton could be over $1 billion; knew about, and agreed to, the lifetime employment and expense and defense indemnity contract with Georgeff in exchange for his testimony; knew that the defendant officers dishonestly suppressed the Georgeff agreement in discovery, thereby exposing Eaton to Frisby's motion to dismiss as a sanction for discovery violations; knew that the special master concluded in December, 2006 that Eaton's counsel had produced discovery responses that were "truly false" in an "intentional effort to mislead"; knew that Peters was then hired in December, 2006 to improperly influence Judge DeLaughter into, among other things, 1) not adopting the special master's finding of discovery violations, 2) vacating earlier findings of the special master already adopted by the court that were adverse to Eaton, 3) forcing on the Frisby defendants the no-win decision of whether to testify under oath in the trade secret case while criminal charges were still pending, and 4) removing Dunbar, the independent special master, and replacing him with a pliable special master; knew that Eaton's vice president of communications lied about why Eaton retained Peters; knew that the company was sanctioned in the trade secret case over $1.5 million in January, 2010 for intentional discovery violations; and knew that the trade secret case was dismissed with prejudice in December, 2010 by an order citing, among other things, "Eaton's failure to take any corrective action" to any of the foregoing.

Eaton acknowledges that all of these allegations are part of the amended complaint, yet argues that they are insufficiently particularized to support a finding that any given board member faces a substantial likelihood of personal liability.[9] That argument is not persuasive.

The essence of the plaintiff's amended complaint is that the directors were fully aware of (if not complicit in) the unethical and illegal tactics Eaton's lawyers used in the prosecution of the trade secret lawsuit, yet consciously chose not to act to prevent or stop the lawyers, and that because the directors did not act the company has lost the opportunity to recover $1 billion in the trade secret lawsuit and has been exposed to liability in two antitrust suits. It is inconceivable that by tolerating such conduct the board members acted other than with reckless disregard to the best interests of the corporation. First the company hid from discovery the evidence that would have allowed Frisby to impeach its vital witness and then, once caught, hired Peters, sub rosa, to unfairly tilt the scales. Putting aside rectitude, the choice of the board to approve, tacitly or otherwise, these tactics was extremely high risk – as evidenced by the current state of affairs – and cannot be considered anything less than reckless.

CONCLUSION

Because the plaintiff has alleged facts that, if true, expose the complicit directors to a substantial likelihood of personal liability there is a reasonable doubt that those directors would have disinterestedly considered a pre-suit demand and the court finds that the first part of the *Aronson* test is satisfied.[10] Seven of the director defendants – Critelli, Cutler, Green, Lautenbach, McCoy, Page and Tooker – are alleged to have been directors from 2004 through

[9] See motion to dismiss, p. 9: [P]laintiff's allegations are far too general to satisfy the requirement of particularity in pleading a substantial likelihood of personal liability for substantial damage.
[10] Not to mention the *Rales* test.

the present. Even assuming that Johnson and Bluedorn, who joined the board in 2009 and 2010, respectively, are disinterested because they were not there to condone all of the worst conduct, that leaves a majority of the 11-member board[11] upon whom a pre-suit demand to sue would be presumptively futile.

Therefore, the defendants' July 15, 2011 motion to dismiss is denied.

IT IS SO ORDERED:

____________________________ Date: ____________________
Judge John P. O'Donnell

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[11] The amended complaint does not include an allegation as to defendant Golden's term of service on the board, and does not name as a defendant current board member Christopher M. Connor.

SERVICE

A copy of this journal entry was sent by email, this 24th day of January, 2013, to the following:

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