LAW360

Portfolio Media, Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@portfoliomedia.com

Case Study: NACCO Industries V. Applica

Law360, New York (January 26, 2010) -- Recently, in NACCO Industries Inc. v. Applica Inc., No. 2541-VCL (Del. Ch. Dec. 22, 2009), the Delaware Court of Chancery declined to dismiss claims of common law fraud arising from allegedly false and misleading statements made in federal securities filings.

The Delaware courts, it held, have jurisdiction to consider such claims and are not preempted by Section 27 of the Securities and Exchange Act of 1934, which confers exclusive jurisdiction to federal courts over actions brought to enforce Exchange Act rules.

Background

In early 2006, Applica Inc. entered into a nondisclosure agreement (NDA) with NACCO Industries Inc. in connection with a potential strategic transaction. The NDA included a standstill provision prohibiting NACCO from acquiring Applica shares in the market. In late July, the parties entered into a merger agreement.

Also in early 2006, defendants Harbert Management Corp., a Harbinger-portfolio company, and its affiliates ("Harbinger") were accumulating shares of Applica's common stock, eventually acquiring nearly 30 percent.

Harbinger disclosed its acquisitions to the U.S. Securities and Exchange Commission, but it made the disclosure on Schedule 13G, which generally requires the disclosing party to certify that it is a passive investor with no plans to control the company. That schedule requires far less disclosure than its analogue, Schedule 13D, filed by nonpassive investors.

Thus, although Harbinger continued to amass a significant position in Applica's stock, it continued to certify on its Schedules 13G that the shares were not bought or held for purposes of changing or influencing control of Applica.

By May 2006, Harbinger owned almost 40 percent of Applica's stock and, as required under the Exchange Act, filed a Schedule 13D, again reporting that the shares were purchased for investment purposes only.

Schedule 13D requires an investor to state the purpose or purposes of its purchase and to describe any plans or proposals it may have that would result in a corporate transaction, such as a merger, reorganization, liquidation or sale with the company.

In September 2006, Harbinger announced its offer to buy all outstanding shares of Applica for $6.00 per share and filed an amended Schedule 13D. Unlike its previous filings, the amended disclosure stated that Harbinger had acquired its shares in order to gain control over Applica.

All Content Copyright 2003-2010, Portfolio Media, Inc.

Applica's board determined that Harbinger's offer constituted a "superior proposal" under its merger agreement with NACCO and, accordingly, terminated that agreement, paying NACCO the $4 million termination fee, as well as the $2 million in expense reimbursement, due to it under the agreement.

Following the termination, NACCO and Harbinger engaged in a month-long bidding war, ending with Harbinger's winning bid of $8.25 per share for the remaining 60 percent of Applica's shares.

The Fraud Claim: State or Federal Jurisdiction

Among other claims, NACCO asserted common law fraud against Harbinger (the "Fraud Claim"), alleging that Harbinger's statements concerning its investment intentions in its Section 13 filings prior to September 2006 were false and misleading.

These filings, NACCO claimed, misrepresented Harbinger's plans concerning Applica — namely, its effort to build a control position in Applica on the cheap while keeping NACCO, and other bidders, at bay.

NACCO asserted that had Harbinger disclosed its true intent to control Applica, NACCO would not have sat idle while Harbinger acquired almost 40 percent of Applica.

Instead, NACCO insisted that it would have demanded a release from the standstill provisions of the NDA or demanded that Applica adopt a rights plan or force Harbinger to agree to a standstill.

NACCO also alleged that Applica's proxy statement regarding the Harbinger transaction, as well as several internal Harbinger emails, directly contradicted statements within Harbinger's Schedule 13 filings.

The proxy statement, NACCO alleged, references discussions between Applica and Harbinger over a potential deal as early as July 2006, when Applica was subject to the no-shop clause in its merger agreement with NACCO, as well as its obligation under that agreement to notify NACCO of any potential third-party transactions.

To these points, NACCO produced emails between Harbinger insiders as early as June 2006 that read: "I think we pay cash for [Applica] — take it private ... the world [would] be knocking on our door ... and we can take the new company public in 24-36 months for a massive gain." Also in June, Harbinger retained a financial advisor to evaluate gaining "full/complete control of Applica."[1]

In determining whether NACCO's common law Fraud Claim based on Harbinger's allegedly false statements in its federal securities filings came within the purview of its jurisdiction, the Chancery Court analyzed the jurisdiction issue at length.

Harbinger argued that the federal courts have exclusive jurisdiction over NACCO's Fraud Claim pursuant to Section 27 of the Exchange Act, which provides that "[t]he district courts of the United States ... shall have exclusive jurisdiction of violations of [the Exchange Act] or the rules and regulations thereunder."

But NACCO directed the court to Section 28(a) of the Exchange Act. That subsection provides that "the rights and remedies provided by [the Exchange Act] shall be in addition to any and all other rights and remedies that may exist at law or in equity ..."

Relying on Section 28(a) as well as a 2001 Delaware Supreme Court case, Rossdeutscher v. Viacom Inc., 768 A.2d 8 (Del. 2001), and referring to several court decisions regarding removal of cases from state court to federal court, the Chancery Court determined that a basis for removal to federal court would exist if NACCO sought to enforce a violation of the Exchange Act or a particular remedy granted by it.

All Content Copyright 2003-2010, Portfolio Media, Inc.

Instead, the court pointed out, NACCO's "real beef" is with the allegedly false statements in Harbinger's Schedule 13G and 13D, on which NACCO, as a bidder for a public company, relied as true and accurate.[2]

The court ultimately held that the Exchange Act does not preempt common law fraud claims; rather, federal claims coexist with state law claims.

Finding that NACCO sufficiently pled a claim for common law fraud under Delaware law, the court noted that it would evaluate the allegedly false and misleading statements in Harbinger's Section 13 filings at trial within the year.

Practitioner Notes

This decision may have significant precedential effect. The Chancery Court has indicated that it will not dismiss outright a well-pled allegation of common law fraud under state law, independently of or in conjunction with a federal law action, even when the allegations are based on statements made in filings required under the federal securities laws.

Practitioners should be aware that, in connection with a transaction involving a Delaware entity, there may be state law liability for false or misleading disclosure, in addition to any liability under the federal securities laws.

This case highlights the expanded role that the Delaware courts will play to ensure Delaware entities do not engage in fraud. "The ability of this court to enforce such a remedy where a Delaware entity has been accused of fraud serves important Delaware interests."[3]

Going forward, to successfully litigate its common law Fraud Claim, NACCO still must prove it had reason to rely on Harbinger's Section 13 filings, and it must demonstrate the extent of its damages.

However, the court made clear that "[i]f a Delaware entity engages in fraud or is used as part of a fraudulent scheme, that entity should expect that it can be held to account in the Delaware courts."[4]

--By Lisa M. Pietrzak, Richards Layton & Finger PA

Lisa Pietrzak is an associate with Richards Layton & Finger in the firm's Wilmington, Del., office.

The opinions expressed are those of the author and do not necessarily reflect the views of Portfolio Media, publisher of Law360.

[1] NACCO Indus. v. Applica Inc., 2009 Del. Ch. LEXIS 217, at*9 (Del. Ch. Dec. 22, 2009).

[2] Id. at *10.

[3] Id. at *42.

[4] Id. at *60.

All Content Copyright 2003-2010, Portfolio Media, Inc.