

**DELAWARE CHANCERY COURT RULING OPENS THE DOOR TO STATE FRAUD
CLAIMS BASED ON SCHEDULE 13D AND 13G DISCLOSURES**

On December 22, 2009, the Delaware Chancery Court issued its decision in *NACCO Industries, Inc. v. Applica Incorporated*, No. 2541-VCL (Del. Ch. Dec. 22, 2009), refusing to dismiss a state common law fraud claim based on faulty disclosures in Schedule 13D and 13G filings. While the federal courts generally have held that monetary damages are not available in private actions asserting violations of Section 13(d) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), Vice Chancellor Laster’s decision gives rise to possible state law claims for monetary damages based on Schedule 13D or 13G disclosures.

In particular, the *NACCO* decision highlights the importance of accurate Schedule 13D disclosures by greater-than-5% beneficial owners that are seeking or may seek to acquire a public company. Adding to the potential consequences under the Exchange Act for inadequate disclosure, the *NACCO* decision raises the possibility of monetary liability to a competing bidder if faulty Schedule 13D disclosures are seen as providing an unfair advantage in the competition to acquire the company.

Factual Background

The *NACCO* litigation arose out of a bidding contest for Applica Incorporated (“Applica”), which publicly announced a “strategic alternatives” process in February 2006. As a result of this process, Applica entered into a definitive agreement to be acquired in a stock-for-stock transaction by a holding company for the Hamilton Beach business of NACCO Industries, Inc. (“NACCO”), which would be spun off to NACCO’s stockholders in connection with the transaction.

Four days before Applica announced its strategic alternatives process, and a month after Applica’s board of directors had authorized merger discussions with NACCO, funds managed by Harbert Management Corporation (“Harbinger”) began purchasing Applica common stock. In March 2006, Harbinger filed a Schedule 13G disclosing that it beneficially owned 8.9% of Applica’s outstanding shares and certifying that those shares “were not acquired and are not held for the purposes of or with the effect of changing or influencing the control of [Applica].” By May 2006, Harbinger had acquired 24.7% of Applica’s outstanding shares and filed a Schedule 13D stating that “the shares . . . were acquired for, and are being held for, investment purposes only.” From May through mid-September 2006, Harbinger increased its Applica holdings to nearly 40%. During this period, Harbinger filed amendments to its Schedule 13D, all of which disclosed that the shares were being acquired and held for investment purposes. It was not until mid-September 2006, when Harbinger announced a competing bid to acquire Applica, that it amended its Schedule 13D to disclose that it had “acquired [the] shares . . . in order to acquire control of [Applica].”

NACCO’s complaint alleged that Harbinger had been actively pursuing a strategy to acquire control of Applica during much of the period since it filed its initial Schedule 13G and that Harbinger had secretly been in contact with members of Applica’s management, who were tipping it as to

Applica's deal process and negotiations. Moreover, NACCO alleged that as early as March 2006, Harbinger had considered the idea of acquiring Applica in order to combine it with another public company, Salton, Inc. ("Salton"). By April 2006, a Harbinger advisor had modeled and recommended a combination of Applica and Salton, and in May 2006 Harbinger had begun to accumulate preferred stock and debt in Salton. In July 2006, two days after the announcement of Applica's merger agreement with NACCO, Harbinger's advisor told a former Salton board member that Harbinger and Salton were going to bid for Applica. The same day, the Salton board approved a bid for Applica that was to be financed by Harbinger.

In October 2006, Applica terminated its merger agreement with NACCO and notified NACCO that it intended to enter into a merger agreement with Harbinger. After unsuccessfully seeking expedited relief in the Delaware Chancery Court to enjoin a merger between Applica and Harbinger, NACCO commenced a bidding contest to acquire Applica, which it ultimately lost. NACCO subsequently continued its action against Applica and Harbinger, asserting, among other counts, a fraud claim based on Harbinger's Schedule 13D and 13G disclosures.

The Decision

In analyzing whether NACCO's claim for common law fraud could survive Harbinger's motion to dismiss, the court first addressed whether it had jurisdiction to consider the fraud claim. The court noted that while the federal courts have exclusive jurisdiction over violations of the Exchange Act, the Delaware Supreme Court has held that statutory remedies under the Exchange Act are "intended to coexist with claims based on state law and not preempt them." The court emphasized that NACCO was not seeking state law enforcement of federal disclosure requirements, but rather had alleged that Harbinger's statements in its Schedule 13D and 13G filings were fraudulent under state law without regard to whether those statements complied with federal law.

Explaining that a misrepresentation regarding intent may form the basis of a fraud claim, the court undertook an analysis of Harbinger's activities and its Schedule 13D and 13G disclosures from March to September 2006. Based on the totality of these activities and disclosures, and assuming that the facts alleged in NACCO's complaint were true for purposes of Harbinger's motion to dismiss, the court found a sufficient basis in the pleadings to conclude that Harbinger had falsely misrepresented its intent in its Schedule 13D and 13G filings.

In refusing to dismiss NACCO's fraud claim, the court rejected Harbinger's argument that a June 2006 Schedule 13D amendment effectively alerted the market that Harbinger was "going active" and therefore prevented an inference that its filings were false. In the June filing, Harbinger had said that it was holding its Applica shares "for investment purposes" rather than "for investment purposes only," as its earlier disclosures had read. In addition, Harbinger's June filing had "reserve[d] the right to be in contact with" Applica's management, directors and others regarding "alternatives that [Applica] could employ to maximize shareholder value." The court found the deletion of the word "only" to be a contrived effort to shield Harbinger against a future dispute and found the language reserving Harbinger's right to contact third parties to be false, as Harbinger had already engaged in communications with Applica's management at the time of the filing.

Similarly, the court was not swayed by Harbinger's argument that "it is widely believed in the community of hedge funds who frequently file Schedule 13Ds that one need not disclose any intent

other than an investment intent until one actually makes a bid.” While commenting that a similarly formalistic, bright-line interpretation of the Schedule 13D requirements had recently been rejected by a federal court, the court stated that it did not have to interpret the requirements of the Exchange Act but rather was confronted with a question as to Harbinger’s intent, which is a question of fact.

Although he denied Harbinger’s motion to dismiss the fraud claim, Vice Chancellor Laster commented that other elements of the fraud claim — reliance and causally-related damages — were close calls based on the record before him. Nonetheless, under the “extreme facts” pled by NACCO, the Vice Chancellor ruled that NACCO can proceed with its fraud theory to seek damages from Harbinger for the loss of its merger agreement with Applica. In doing so, the Vice Chancellor emphasized the narrowness of his decision and that on a more complete record after trial he might conclude that Harbinger did not engage in fraud, that NACCO did not establish that it would not have lost the Applica merger deal without Harbinger’s fraud or that the connection between the loss of the deal and the fraud is too attenuated to impose liability on Harbinger.

Implications

The Chancery Court’s holding potentially opens the door to state law claims for monetary damages based on fraudulent disclosures in Schedule 13D and 13G filings. As such, the court’s decision underscores the importance of accurate and thorough disclosures in Schedule 13D and 13G filings, particularly in anticipation of or during merger and acquisition transactions, where there is the potential for substantial monetary damages. Each case, of course, depends on a very specific set of facts, and the *NACCO* decision provides yet another important reason why beneficial ownership disclosure must be accurately and thoughtfully crafted in light of what are often complicated and dynamic situations.

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If you have any questions concerning this memorandum or Schedule 13D or 13G disclosure obligations, please contact Steven J. Gartner (212-728-8222, sgartner@willkie.com), Michael A. Schwartz (212-728-8267, mschwartz@willkie.com), or the Willkie attorney with whom you regularly work.

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