Hunton & Williams
Mergers & Acquisitions Update

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Delaware Court Rules on M&A Bidding War and No-Shop Provision

On December 22, 2009, the Delaware Court of Chancery issued an important decision in *NACCO Industries, Inc. v. Applica Incorporated*, where it refused to dismiss claims brought by a jilted buyer against a target corporation for breaching the no-shop provisions of a merger agreement. The potential buyer alleged that the target failed to comply with notice requirements set forth in the merger agreement when the target responded to a topping bid from hedge fund Harbinger Capital Partners. Equally important, the court refused to dismiss the potential buyer's common-law fraud claims against Harbinger based on allegedly false statements made in Harbinger's Schedule 13D filings. The potential buyer claimed that Harbinger fraudulently concealed its intent to acquire control of the target. The potential buyer also claimed that Harbinger tortiously interfered with its merger agreement with the target. The decision demonstrates that Delaware courts will enforce deal protections to give parties the benefit of their agreement. It should also cause activist hedge funds to evaluate their disclosures carefully.

Background

The litigation centered on NACCO Industries' ("NACCO") failed acquisition of Applica Incorporated ("Applica"), which was ultimately acquired by affiliates of Harbinger Capital Partners ("Harbinger"). In February 2006, Applica announced that it was exploring strategic alternatives, and by July 2006 it had entered into a merger agreement with NACCO. Throughout this period, Harbinger had been purchasing Applica shares in the open market and held over 30 percent of Applica's common stock when the NACCO merger was announced. In its initial Schedule 13D, in which Harbinger was required by federal securities laws to disclose its stock holdings and investment intent, Harbinger stated that the shares "were acquired for, and are being held for, investment purposes only." In a subsequent filing, however, Harbinger repeated that disclosure but omitted the word "only."

After the merger was announced, Harbinger continued acquiring shares until it owned nearly 40 percent of Applica's stock. It then announced an all-cash offer to acquire Applica at $6.00 per share and amended its Schedule 13D accordingly. Applica informed NACCO that Harbinger's offer was reasonably likely to constitute a "Superior Proposal" (as defined in the merger agreement), thus permitting Applica to negotiate with Harbinger. Less than five weeks later and with little further notice to NACCO, Applica terminated the merger agreement and accepted Harbinger's proposal. A bidding war then ensued between NACCO and Harbinger, with Harbinger eventually acquiring Applica for $8.25 per share.

Court of Chancery's Opinion

Breach of the Merger Agreement

The court refused to dismiss NACCO's claims for breach of the merger agreement. The merger agreement contained fairly standard deal-protection provisions that prevented Applica from soliciting third-party proposals and required it to keep NACCO "informed promptly of the status and terms" of any such proposal. NACCO alleged that Applica's management had been tipping Harbinger both before and after the NACCO merger was announced, including a suggestion to Harbinger that an all-cash offer would successfully top NACCO's merger. NACCO also alleged that Applica effectively went "radio silent" between the time it received Harbinger's proposal and when it terminated the merger agreement just over four weeks later.

The court found these allegations sufficient to plead a breach of the merger agreement. The court wrote that "Applica did not act in a commercially reasonable fashion by effectively going radio silent." It observed that, "in the context of a topping bid, days matter," and NACCO could "reasonably expect Applica to have regularly picked up the phone" to keep it informed on a current basis.

The court then addressed the defendants' argument that, because NACCO lost the resulting bidding war, it could not prove damages stemming from the breach:

> If embraced as grounds for a pleadings-stage dismissal, the defendants' theory would have serious and adverse ramifications for merger and acquisitions practice and for our capital markets. Parties bargain for provisions in acquisition agreements because those provisions mean something. Bidders in particular secure rights under acquisition agreements to protect themselves against being used as a stalking horse and as consideration for making target-specific investments of time and resources in particular acquisitions.

The court concluded that NACCO is entitled to seek "full expectancy damages" or an "alternative damages measure, such as its reliance interest," at trial.

Fraud Claims

The court also refused to dismiss NACCO's common-law fraud claims based on Harbinger's Schedule 13D filing, finding that such claims did not have to be brought exclusively under federal securities laws. In essence, NACCO argued that, had it known of Harbinger's true intent, it would have taken various actions to protect its deal, such as requesting Applica to adopt a rights plan or enter into a standstill agreement with Harbinger. For pleading purposes, the court agreed with NACCO and found that Harbinger had made false statements by, among other things, disclosing that it was acquiring Applica stock "for investment purposes only" and had "no plan or proposal" to engage in a merger or other extraordinary transaction. It also rejected what it perceived to be Harbinger's technical arguments about the accuracy of its disclosures. "[T]he dropping of the word 'only,'" the court observed, "is a fig leaf" and "suggests a minimalist revision contrived to provide an argument if a future dispute arose." It further rejected Harbinger's argument that the Schedule 13D disclosures reserving Harbinger's right to contact Applica management and other similar statements were M&A market vernacular for "we are going active," finding that they were not "sufficiently clear to merit a pleadings stage dismissal."

On a motion to dismiss, the court was required to assume the truth of the allegations in the complaint, but NACCO's complaint was also informed by discovery of numerous emails that contradicted Harbinger's Schedule 13D filings. For example, an April communication suggested that Harbinger should use its voting block "to keep the bidders honest" or to "bid for [Applica] outright ourselves," while another internal email allegedly stated that "we pay cash for [Applica]—take it private." These internal communications, combined with allegations that Harbinger had been in contact with Applica and had continued to accumulate Applica stock, allowed the court to infer that Harbinger "was not reserving the right to consider 'alternatives,' " but instead was fraudulently concealing its intent to acquire the company.

Tortious Interference

Finally, the court refused to dismiss NACCO's tortious interference claims against Harbinger. First, the court found that Harbinger intentionally engaged in contacts and communications that were in breach of the merger agreement's exclusivity provisions. Second, the court held that Harbinger's allegedly fraudulent intent to conceal its motives went beyond "legitimate vehicles of competition." Third, the court found that Harbinger "obtained an unfair advantage over NACCO by accumulating a large stock position based on false disclosures."

Implications of *NACCO*

This decision should generate significant commentary, and M&A practitioners will continue to monitor the litigation. NACCO must still establish its damages, including its reliance on Harbinger's allegedly false statements. The court expressed some doubt on these issues. After all, NACCO ultimately was outbid by Harbinger. What may be pivotal is the fact that Harbinger was able to obtain nearly 40 percent of Applica's shares while concealing its true intent. Thus, "every time NACCO put a dollar on the table, Harbinger could match with 60 cents" as a result of its alleged fraud.

On a broader level, *NACCO* demonstrates that Delaware courts will enforce reasonable deal protection provisions. Many Delaware decisions addressing “material adverse effect” clauses and specific performance remedies are properly viewed as “seller friendly,” but *NACCO* should give buyers significant comfort. While a topping bid’s success depends on numerous factors, buyers that have invested significant time, money and energy in a transaction have a valid interest in being kept informed on a current basis and expecting that negotiated “last look” or matching right provisions will be enforced. As the court observed, buyers use deal protections “to protect themselves against being used as a stalking horse and as consideration for making target-specific investments of time and resources,” and a target’s breach can be enforced through “injunctive relief and specific performance, and, in the appropriate case, through monetary remedies including awards of damages.” Deal protection provisions, therefore, should be drafted carefully.

Conversely, targets must be wary of agreeing to deal protection provisions that may improperly restrict the board’s exercise of its fiduciary duties. Following *NACCO*, targets can expect intense focus on deal protection provisions, which must be addressed on a case-by-case basis in light of such factors as the target’s pre-signing marketing efforts, the likelihood of a topping bid, the premium of the current proposal, and the aggregate effect of all deal protections in potentially precluding a successful topping bid.

NACCO is also a reminder to target boards about the proper role of management in both conducting a sale process and responding to a topping bid. Management’s role in facilitating Harbinger’s offer was important to the court. NACCO alleged that management tipped Harbinger about the proposal and then tilted the playing field in its favor once Harbinger’s bid was announced. NACCO further combined these allegations with a motive: “Applica senior executives knew their jobs were at risk in a strategic deal with [NACCO], which already had a management team, and that Applica’s insiders therefore favored Harbinger as a financial buyer who was likely to retain them.” Prior Delaware decisions, including *Netsmart* and *Lear*, have similarly illustrated the potential pitfalls of management’s close involvement in a sale process.

Another lesson of *NACCO* is how to deal with large target stockholders. It is not clear whether NACCO sought a voting agreement or otherwise approached Harbinger about the transaction, even though Harbinger owned more than 30 percent of Applica’s shares when the merger was announced. NACCO should also have been concerned when Harbinger continued to acquire Applica stock. NACCO allegedly received assurance from Applica management that Harbinger would support the deal, but buyers should always understand and monitor the target’s stockholder base.

Finally, *NACCO* should grab the attention of activist hedge funds and even private equity firms. The court expanded the potential liability of these parties by permitting common-law fraud claims based on the contents of securities filings, though without creating a broad doctrine. The court also upheld tortious interference claims based on, among other things, Harbinger’s collusion with management that was breaching the merger agreement. Like the New York federal district court’s decision last year in *CSX Corporation v. The Children’s Investment Fund Management (UK) LLP*, this decision should heighten scrutiny of activist hedge fund disclosures. It also suggests an increased role at the state level, as the court made clear that “Delaware has a powerful interest of its own in preventing the entities that it charters from being used as vehicles for fraud.”

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