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When Is a Spin-Off "Possible"? *Eaton* 10b-5 Litigation Heads to the Second Circuit

By Donald P. Board • Wood LLP

What do you say when your mother tells *Vanity Fair* that it's "possible" that your biological father was actually Frank Sinatra, not Woody Allen? If you're lawyer-journalist Ronan Farrow, winner of a 2018 Pulitzer Prize, you manage the awkwardness with a disarming tweet: "Listen, we're all *possibly* Frank Sinatra's son."

It's hard not to sympathize with Mr. Farrow. We can even concede his point about Ol' Blue Eyes, provided we take "possible" in a very broad, "theoretical" sense. After all, there are countless even stranger states of affairs—*e.g.*, the world portrayed in *The Matrix*—that are *theoretically* possible.

In regular life, however, we set the "possibility" bar a good deal higher. When we consider a proposed course of action, we want to know whether it's *practically* possible. Statements about what is possible in this everyday sense depend on networks of assumptions that vary based on who is talking to whom, their priorities, and the circumstances in which the statements are made.

That sounds like a lot to keep track of. But there is generally no need to spell out these assumptions when members of the same "culture" engage in *bona fide* communication. This includes CEOs of public companies, investment bankers, securities analysts, and other card-carrying members of the culture of U.S. big business and high finance. Participants in this culture have shifting and sometimes conflicting interests, but they are rarely in the dark about what *other* participants assume or care about in a given situation.

Claims about what is "possible" in a business or financial context constantly draw on these shared understandings. Reliance on unstated assumptions is typical of in-group communication of all sorts. Participants can exchange information with remarkable efficiency, because so much of what they express and understand rests on propositions that are left unsaid.

The *Eaton* Litigation

But sometimes the wires can get badly crossed. A recent case in the Southern District of New York [*In re Eaton Corporation Securities Litigation*, DC-NY, No. 1:16-cv-05894], now on appeal to the Second Circuit, illustrates what can go wrong when participants on *one* side of an in-group conversation flout the shared understanding of what counts as "possible."

The case has its origin in Eaton Corporation's 2012 inversion with Cooper Industries plc. Moving Eaton's domicile to Ireland lowered the company's effective tax rate, just as intended. But, for technical reasons involving Code Sec. 355 (discussed below), the transaction also deprived Eaton of the ability to spin off any of its existing business in a tax-free transaction for *five years* following the closing.

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As soon as plans for the inversion were announced (May 21, 2012), analysts began asking whether the transaction might create a problem for future divestitures. Eaton and its senior executives assured them that the company could still do spin-offs—if it *wanted* to. But they always added that the company was satisfied with its existing portfolio, implying that the question was moot.

Eaton hewed to this line for more than two years. On July 29, 2014, however, the CEO told analysts that he wanted to clarify something. He then acknowledged: (1) that the 2012 inversion had barred the company from using Code Sec. 355 for five years; (2) that spin-offs executed before late in 2017 would subject Eaton to "very significant" tax liability; and (3) that this tax problem would "obviously" undercut the case for any divestiture.

Suddenly, spin-offs went from being what the CEO called "an issue of will" to being *impossible* as a practical matter. Eaton's stock fell by eight percent, wiping out $3 billion of market capitalization. In 2016, investors sued Eaton and two individuals (including the CEO) for fraud under SEC Rule 10b-5.

So far, the lawsuit has gone nowhere. Last fall, the District Court dismissed the case *on the pleadings*. [*See In re Eaton Corp. Sec. Litig.*, 2017 WL 4217146 (Sept. 20, 2017) ("*Eaton I*").] The plaintiffs amended their complaint, but in July the judge dismissed the case yet again, this time with prejudice. [*See In re Eaton Corp. Sec. Litig.*, 2018 WL 3597512 (July 20, 2018) ("*Eaton II*").]

According to the District Court, the defendants had asserted only that it would be "possible" for Eaton to do spin-offs following the inversion. They had never claimed that the transactions would be "feasible" or "workable" if tax consequences were taken into account. The defendants' statements were not actionable under Rule 10b-5, because they were *true*.

The District Court also held that the defendants had no duty to disclose that tax considerations had made spin-offs completely impractical for five years. Rule 10b-5 prohibits only failures to disclose *material* facts. Because the defendants had stated that Eaton had no plans to divest itself of any businesses, it was *immaterial* that spin-offs would not be feasible until 2017.

The Ruritanian Connection

Eaton has been briefed twice, so the relevant case law is on the table. The parties will march through it all again for the Second Circuit. What may be missing, however, is a perspective that takes account of how communication among non-lawyers actually works.

Let's set up a hypothetical to highlight the question of what "possible" means to public companies and the analysts who are the stock market's eyes and ears. To avoid distracting technicalities, we will keep tax out of it.

Acme Corporation has some terrific news. The government of Ruritania has offered to give Acme's Freedonian subsidiary access to the lucrative Ruritanian market. All Acme has to do is provide the Ruritanian government with the specifications for a sensitive technology that Acme has developed.

Alarmed, the U.S. government privately notifies Acme that disclosing the technology will violate federal law. Washington warns that sharing the information will subject Acme to civil and criminal liability, and to termination of its government contracts.

Acme shares are up 20 percent, but analysts are hearing rumors that the transaction has hit the regulatory rocks. They ask Acme's president to confirm that it is still "possible" that Acme will take the Ruritanians up on their offer. Ms. President does not think this is the right time to disclose the U.S. government's warnings, so she responds as follows:

> Is it still possible for us to do deal? Absolutely. And let me assure you that we are fully confident in our ability to provide our Freedonian subsidiary with access to the Ruritanian market by sharing our world-class technology.

A few days later, Acme announces that the deal is off. Acme's stock drops sharply, and investors are furious. They sue Acme and Ms. President for fraud under SEC Rule 10b-5.

Ms. President maintains that everything she said was *true*. It was certainly "possible," she observes, for Acme to move ahead on its side of the transaction. All she had to do was call the IT Department, which could have sent the Ruritanians the requested specs before she hung up the phone.

The government of Ruritania is not to everyone's taste, but it *does* keep its promises in commercial matters. There is no reason to assume that the Freedonian subsidiary would *not* have obtained access to the Ruritanian market if Acme had disclosed the technology. So, Ms. President contends that Acme had the "ability" to do exactly what she claimed it could.

At this point, readers may be rolling their eyes. Okay, the technology-for-access swap was *theoretically* possible. But everyone—including Ms. President—would have known full well that this was *not* what the analysts were asking about.

Here, as in most business contexts, a transaction that is grossly impractical cannot be described as "possible" without qualification. Acme could not disclose the technology without triggering civil and criminal liability and severe economic consequences. The transaction was *not* "possible" in the culturally relevant sense. For the same reason, Acme did not *really* have the "ability" to provide its subsidiary with access to the Ruritanian market.

It is at least arguable that Ms. President's claims were *false*. In the context in which it was uttered, "possible" meant *practically* possible. The fact that she had her semantic fingers crossed doesn't change that. Even if she was silently reciting that she meant only that the transaction was *theoretically* possible, her statements were still misleading, as she would have known.

We will come back to Acme and Ms. President. But first let's take a closer look at: (1) what Eaton said about the "possibility" of future spin-offs; and (2) the District Court's rationale for dismissing the lawsuit for failure to state an actionable claim.

Inversions *Versus* Spin-Offs

Eaton's new Irish mailing address reduced its effective tax rate. But the inversion still had two tax drawbacks, starting with the tax treatment of the inversion itself. The transaction was designed to qualify as a reorganization under Code Sec. 368(a)(2)(E). But the cross-border element triggered Code Sec. 367(a)(1), which "turns off" reorganization treatment unless an exception applies.

To get non-recognition treatment under Code Sec. 354, Eaton's U.S. shareholders needed to qualify under Reg. §1.367(a)-3(c)(1)'s exception for certain transfers of stock of a U.S. corporation. Unfortunately, the U.S. shareholders received 73 percent of the post-inversion Eaton. This put them on the wrong side of the regulation's 50-percent ownership cap.

Consequently, Eaton's U.S. shareholders were taxed when they exchanged their original shares for stock of the post-inversion company. Irritating, to be sure, especially since they did not receive any cash to pay the tax. But at least Easton *disclosed* the adverse tax treatment before the shareholders approved the deal.

The second tax drawback was a subtle consequence of the first. "New" Eaton acquired control of "old" Eaton, together with all the businesses conducted by its subsidiaries, in a transaction in which some gain *was* recognized—*viz.*, to the U.S. shareholders. Under a literal reading of Code Sec. 355(b)(2)(D), this would cause any spin-off executed before late in 2017 to fail the trade-or-business requirement. This result may be a statutory accident, but it made it *practically* impossible for Eaton to execute a spin-off for five years. [*See* Donald P. Board, *Tell It to Your Analyst? Inversions, Spin-Offs, and Rule 10b-5*, THE M&A TAX REPORT 1, 6-7 (Dec. 2017).]

According to Eaton's CEO, the company knew that it was subjecting itself to this strategic disability when it did the inversion in 2012. If so, it is surprising that Eaton did not mention the problem in the *proxy statement* it used to solicit shareholder approval of the transaction.

Truth About Consequences?

Realistically, the meaning of "possible" depends on context, so let's review Eaton's conversations with the analysts who were following the company's every move. As soon as the inversion was announced, analysts asked about its implications for Eaton's sluggish automotive-parts business. Would Eaton be "precluded by any element of the tax structure of the deal to spin off the truck and auto [business] … at any time?"

The CEO responded that there was "nothing in the deal *per se* that would prevent us from taking portfolio moves." This may have sounded encouraging, but it disregarded the fact that "the tax structure" *did* effectively prevent divestitures, as the CEO acknowledged in 2014. The CEO's reference to "the deal *per se*" suggests that he may have been trying not to go on record about the inversion's tax-related consequences.

The CEO may have intended a similar distinction in a statement he made shortly before the inversion closed. In response to a question about the transaction's effect on Eaton's "ability to divest businesses," he replied that there was "nothing … in our deal structure or any of our covenants that … prevents us from making changes in our portfolio."

This may also have sounded encouraging. But Eaton's deal covenants would not have been concerned with future divestitures, so there was no point in mentioning them. Although "deal structure" might include the tax consequences of the inversion, the CEO may have been distinguishing between the structure of the inversion *per se* and its tax implications.

On May 21, 2013, about six months after the inversion was completed, the CEO was faced with a different type of question about the tax issue. This time the analyst asked whether there was "[a]nything about the way the tax structure has formed over time [that] would *constrain* things you might do strategically, whether that were a larger-scale divestiture or anything else." (Emphasis supplied.)

The analyst was not asking the CEO to opine on whether divestitures were still "possible." The question was whether there were any tax considerations that would "constrain" what the company might do to effect a large divestiture. The CEO responded in the negative:

> On the tax issue, no, we are domiciled outside the US. We've got great flexibility in terms of how we are able to move cash around the world, and that really is the issue that gives us our great strategic flexibility. So, I would say 'no' on that one.

The CEO's answer was problematic. Eaton had known since 2012 that the inversion would create a tax problem that would certainly *constrain* what it might do by way of divestitures. As the CEO acknowledged in 2014, the "very significant" tax liability would fundamentally alter

the economics of any large divestiture—and not in a good way.

Perhaps the CEO misunderstood the question. But he was not the only person at Eaton who knew that the inversion had created a gigantic tax-related constraint. Since it was obvious that the CEO's answer would mislead analysts, why didn't Eaton issue a correction?

District Court Decision, Part II

The District Court described the amended complaint as alleging that the defendants' statements about Eaton's "continued, unconstrained ability" to divest itself of its vehicle business were *false*. The plaintiffs' experts had opined that the tax problem had made it prohibitively expensive for Eaton to spin off its automotive business. The District Court did not think this was sufficient to survive the defendants' motion to dismiss:

> [T]hese expert opinions do not *contradict* the defendants' statements—because the defendants never commented on the economic viability of a taxable sale of the vehicle business or whether such a sale would be value creating for the Company. Rather, the defendants stated that such a spin-off would be *possible* but further noted that they were not contemplating such a spin-off. They said nothing about the expense of such a spin-off or sale, if it were to be completed. *The expert opinions offered in the [amended complaint] therefore do not show that the defendants' statements that a spin-off of the vehicle business was possible were false*. [*Eaton II*, *supra*, at *8 (emphasis supplied).]

The District Court made a parallel point when it rejected the plaintiffs' allegation of *scienter*:

> The defendants never spoke to the economic feasibility of a potential spin-off of the vehicle business, and they never stated that the transaction could be completed in an economically feasible way or as a tax-free spin-off. The defendants only stated that a vehicle spin-off was *possible*, without making any representations as to the economic workability of such a spin-off. [*Id.* at *9 (emphasis supplied).]

Ruritania Redux

How would the District Court's analysis in *Eaton* apply to Acme's proposed transaction with the Ruritanians? If Ms. President had given the word, the IT Department would have transmitted the requested information. This would have had disastrous consequences for Acme, but it was still *possible* for the company to do what the Ruritanians wanted.

Disclosing the technology would have violated U.S. law. But there is no reason to assume that either Ruritania or Freedonia would have prevented Acme's subsidiary from taking advantage of its new market access. So, Ms. President could certainly argue that the second leg of the Ruritanian transaction was "possible," too.

Under *Eaton*, Ms. President would now be home free. We can imagine an excerpt from the opinion dismissing the hypothetical complaint:

> The defendants never spoke to the legal or economic feasibility of disclosing the technology, and they never stated that the transaction could be completed in a legally or economically feasible way. The defendants only stated that a technology-for-access swap was *possible*, without making any representations as to the legal or economic workability of such a swap.

Would this argument fly? When the analysts asked whether it was "possible" for Acme to do the swap, the legal and economic "workability" of the transaction was *precisely* what they are asking about. Telling analysts that a transaction is "possible" when it is plainly *impossible* in the culturally relevant sense seems like the kind of conduct that Rule 10b-5 is supposed to prevent.

"Impossible" *Versus* ***"Constrained"***

It is also notable that the CEO's statement on May 21, 2013 did not concern the "possibility" of divestitures in the wake of the inversion. The analyst asked whether there was anything in "the tax structure" that would "constrain things you might do strategically, whether that were a larger-scale divestiture or anything else."

A constraint limits or restricts a person's freedom of action in some domain. It need not—and typically does not—absolutely

prevent the person from taking some form of action. Constraints limit our options, but they do not generally *eliminate* them.

Budgetary constraints do not necessarily mean that you *can't* throw a party. But they can certainly affect your decision *whether* to throw one. They can also affect the kind of party you throw, when you throw it, and so on.

Suppose that an entertainment analyst asks Harvey Host, dean of the local party scene, whether there is "anything in your budget that would constrain things you might do this weekend, whether that were a larger-scale party or anything else." In fact, Mr. Host is on a very strict budget for the next six months. Faced with this constraint, he is under pressure to forgo a party, limit the number of guests, make it a BYOB affair, *etc.*

Mr. Host is embarrassed that he cannot entertain as lavishly as usual. He replies as follows:

> On the budget issue, no, I live in a great building and I've got a below-market lease. I've got great flexibility in terms of how I am able to move my furniture around, and that really is the issue that gives me my great social flexibility. So, I would say "no" on that one.

Is this an honest answer? Mr. Host was asked whether there was anything in his budget that might *constrain* anything he might do this weekend, including with respect to throwing a big party. Mr. Host's answer denied the existence of constraints, although he knew this was false.

"False" *Versus* ***"Misleading"***

The District Court argued that the plaintiffs had failed to plead facts indicating that the defendants' statements were *false*. As discussed above, there is a real sense in which claiming that spin-offs were still "possible" *was* false. But let's assume (with the District Court) that a transaction is "possible" as long as it is *theoretically* possible.

Did the plaintiffs have to show that the defendants' about the (theoretical) possibility of a spin-off were false? Rule 10b-5 certainly prohibits false statements. But it also makes it unlawful to fail to state a material fact necessary to prevent another statement (which may be *true*) from being "misleading" in light of the circumstances under which it was made. In other words, Rule 10b-5 bans both falsehoods *and half-truths*.

The *Eaton* plaintiffs needed to establish that the defendants' statements—if left unqualified—were misleading under the circumstances, not that they were false. Even granting that the opinions of the plaintiffs' experts did not "contradict" the claim that it was *possible* for Eaton to do a spin-off, that should not have been the end of the analysis.

The experts' opinions that spin-offs had been rendered infeasible provided a strong basis to conclude that the defendants' statements about "possibility" were *half-truths*. In that case, failure to disclose the tax-related constraints would have been actionable under Rule 10b-5, provided that: (1) the omitted statements were material; and (2) the defendants acted (or failed to act) with *scienter*.

Mind Over Material

The District Court never came to grips with the half-truths issue. Eaton had denied any intention to divest itself of any of its businesses. That was enough to establish that the company's inability to do tax-free spin-offs was not "material" for purposes of Rule 10b-5.

Obviously, we cannot require public companies to spend all day disclosing the myriads of things that they do *not* plan to do, much less their hypothetical tax consequences. In fact, we do not even require companies to address specific rumors about their plans. If asked about the "word on the Street," a public company can simply decline to comment.

However, once a company addresses—or *purports* to address—a topic, it may not distort the market with half-truths. If the company pollutes the information environment with half-truths, it must clean up the mess. This means disclosing any (material) facts necessary to prevent investors from being misled by the company's statements.

Were the tax consequences of the inversion for future spin-offs immaterial? Eaton had disavowed any *present* intention to do a spin-off. But companies, like people, change their minds, particularly as new circumstances warrant. Their officers and directors, as fiduciaries, may have a legal duty to do so.

Securities analysts, who must consider *multiple* scenarios, would obviously have cared about Eaton's practical ability to do tax-free spin-offs, not just Eaton's intentions. The fact that Eaton had said it was happy with its existing portfolio did not make the question irrelevant to a reasonable investor or analyst. The market's sharp negative response when the truth finally came out is not surprising.

The District Court argued that changes in market prices are not determinative on the question of materiality, and that they cannot serve as the sole basis for finding materiality in a complaint. The amended complaint was supposedly "devoid" of any other allegations supporting a finding of materiality.

Of course, even the CEO acknowledged that it mattered whether spin-offs were just an "issue of will" or were barred by "some very technical [tax] issues." When the stock price dropped following the CEO's disclosure, analysts did not hesitate to attribute the market's reaction to the fact that spin-offs were now known to be off the table until 2017. But this cut no ice with the District Court, because Eaton had said that it did not want to do any divestitures.

Scienter *and Incentives*

To be liable under Rule 10b-5, a defendant must act (or fail to act) with *scienter*. This requires an "intent to deceive, manipulate, or defraud, or at least knowing misconduct." [*SEC v. First Jersey Sec., Inc.*, CA-2, 101 F3d 1450, 1467 (1996) (internal citations omitted).] The plaintiff must allege facts: (1) showing that a defendant had "both motive and opportunity to commit the fraud," or (2) constituting "strong circumstantial evidence of conscious misbehavior or recklessness." [*ATSI Communications, Inc. v. Shaar Fund, Ltd.*, CA-2, 493 F3d 87, 99 (2007).]

The District Court held that the *Eaton* plaintiffs had not adequately pleaded *scienter*. In its view, there was "no reason for any executive to be dishonest about the tax consequences of a hypothetical merger [*sic*: divestiture] that the Company repeatedly and explicitly stated it had no plans to do." [*Eaton II*, *supra*, at *8 (quoting *Eaton I*, *supra*, at *11.]

"No reason" seems like an overstatement. The circumstances in which the inversion occurred created obvious incentives (or "reasons" or "motives") for Eaton's executives to conceal how the transaction was going to constrain the company's future spin-off options.

From the outset, analysts had wondered how the inversion would affect potential divestitures. A number of analysts had maintained that Eaton's retention of low-growth businesses was depressing its stock price. From their perspective, forfeiting the right to use Code Sec. 355 for five years would have made a bad situation even worse.

If analysts had loudly criticized the proposed inversion, this might have mobilized shareholder opposition to the transaction. Disclosure of the Code Sec. 355 problem could also have hurt Eaton's stock price (as it did in 2014). That could have affected the exchange ratio, increasing the stock "cost" of completing the deal.

Human and corporate nature being what they are, Eaton and its senior executives would have wanted to present the inversion in the best possible light. They would certainly have *hoped* to avoid criticism and controversy. This would have given the defendants a completely intelligible *motive* to conceal the tax implications of the inversion until after the transaction closed.

What about afterwards? Suppose that the defendants stepped over the line—or even embarrassingly *close* to the line—in their efforts to get the shareholders to approve the deal. That would have created an incentive to conceal the problem even *after* the closing.

Appeal to the Second Circuit

The plaintiffs have filed a notice of appeal. Will the Second Circuit take a more realistic view of the case? If one considers what securities analysts actually do, it is hard to deny the materiality of Eaton's undisclosed problem under Code Sec. 355. The fact that Eaton had no plans to change its portfolio was *also* material, but it hardly rendered all *other* facts immaterial.

A more realistic view of Eaton's "conversations" with analysts could also cast the case in a different light. Claiming that spin-offs were "possible" when they were completely impractical for tax reasons had an obvious potential to mislead. Denying that tax considerations might even "constrain" a future transaction pushed the risk still higher.

A complaint sufficiently alleges *scienter* under Rule 10b-5 only if "a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged." [*Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 US 308, 323 (2007).]

How this test is applied will depend on what the Second Circuit—standing in for the "reasonable person"—concludes regarding the defendants' incentives to mislead analysts. The District Court saw no reason for Eaton's executives to dissemble. A more realistic analysis would consider whether the defendants' desire to complete the inversion would have given them a rational motive to suppress the bad news concerning Code Sec. 355. Even after the closing, normal concerns about reputation, potential liability and Eaton's stock price would have created rational incentives for the defendants to continue to deny the existence of tax-related constraints.

"Listen, We Could All *Possibly* Do a Spin-off"

Does commercial reality matter in securities pleading? Or is it just a big word game? The Second Circuit, historically our greatest commercial court, will make that call.

If a lodestar is needed, the Court of Appeals might ask itself: How would Learned Hand have approached this case? Those bronze busts in the courtroom aren't there just for decoration, after all.

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