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Tell It to Your Analyst? Inversions, Spin-Offs, and Rule 10b-5

By Donald P. Board • Wood LLP

Policy-makers, legislators and tax administrators continue to disagree about what, if anything, should be done about corporate inversions. But while that debate rolls on, this much seems clear: CEOs of expatriating companies can find it extremely challenging to even *talk* about the role of taxes in these controversial transactions. Senior managers' responses to apparently straightforward questions from Wall Street analysts have led to misunderstandings that are almost as mega as the deals themselves.

In the summer of 2014, for example, a surge in inversions was attracting attention in Washington. In July, President Obama blasted expatriating companies as "corporate deserters" that were "gaming the system." Observers suspected that the Treasury Department was on the verge of issuing yet more rules to limit the tax benefits of moving a U.S. corporation's domicile overseas.

Much speculation focused on the potential consequences for the pending inversion of biopharmaceutical giant AbbVie, Inc., with Ireland's Shire plc. If new rules were issued, would AbbVie still close the $55 billion deal? Or would it walk away, despite the $1.64 billion break-up fee it would incur for leaving Shire at the altar?

Analysts from several Wall Street investment firms put these questions to AbbVie's CEO on a conference call. The chief executive responded that the planned combination had "excellent strategic fit and … compelling financial impact well beyond the tax impact." According to the CEO, AbbVie "wouldn't be doing the deal if it was just for the tax impact." [*See* Donald P. Board, *Tax Inversions, Strategic Benefits and Rule 10b-5*, THE M&A TAX REPORT (Oct. 2016).]

Wall Street heard this as assurance that AbbVie would complete the transaction with Shire even if the tax rules changed. When the IRS announced that it was clamping down on inversions [Notice 2014-52, IRB 2014-42, 712 (Sept. 22, 2014)], the two companies' stock prices held firm.

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Just three weeks later, however, AbbVie stunned the market by announcing that it was not going to close the deal after all. Shire's stock price immediately plummeted by 27 percent. Investors and analysts were particularly surprised that AbbVie was now saying that the new *tax rules* had torpedoed the inversion.

Purchasers of the Irish company's shares responded to this little misunderstanding by suing AbbVie and its CEO for securities fraud. So far, however, they have not met with success. Although the litigation continues, the shareholders' claims based on the CEO's colloquy with the analysts have actually been dismissed. [*See Rubinstein et al. v. Gonzalez and AbbVie, Inc.*, DC-IL, No. 1:14-cv-09465 (Mar. 29, 2016).]

The *Eaton* Case: Background

A recent decision in the Southern District of New York provides an even more striking illustration of the tax "communications gap." The case grew out of the inversion of Eaton Corporation (Eaton) with Cooper Industries plc (Cooper) in 2012. This time, the issue was whether the CEO had misled investors regarding certain tax-related *consequences* of the inversion, as opposed to the role of tax in motivating the deal. [*In re Eaton Corporation Securities Litigation*, DC-NY, No. 1:16-cv-05894 (Sept. 20, 2017).]

Eaton was founded in 1911 to manufacture Torbensen internal-gear truck axles. For most of the 20th century, the company was a successful manufacturer of parts for the booming automotive industry. Over time, it also expanded into the electrical, hydraulic and aerospace sectors.

Eaton's automotive-manufacturing group continued to produce solid returns in the 21st century. But Eaton's higher-tech businesses came to dominate the company's prospects for significant future growth. A number of investors and analysts contended that it was time for Eaton—which now styled itself a "power management company"—to divest itself of the automotive business.

2012 Inversion—Immediate Tax Consequences

In the midst of these strategic speculations, Eaton was negotiating a $13 billion inversion with Cooper. The transaction, announced on May 21, 2012, called for the creation of a new Irish parent company, Eaton Corporation PLC (Eaton PLC), to own both Eaton and Cooper. Eaton shareholders would receive 73 percent of Eaton PLC's stock; shareholders of Cooper would get 27 percent plus a nice stack of cash.

Because Eaton's shareholders would come away with less than 80 percent of Eaton PLC, the new company would be respected as a foreign corporation under Code Sec. 7874(b). However, because Eaton's shareholders would own more than 60 percent, Eaton PLC would be treated as a "surrogate foreign corporation." [Code Sec. 7874(a)(2)(B).]

As a consequence, the expatriated company (Eaton) would face restrictions on its ability to use its U.S. tax attributes to offset its current or future "inversion gain" as defined in Code Sec. 7874(d)(2). But Eaton said it did not expect to recognize any inversion gain, so this wouldn't be a problem.

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EDITOR-IN-CHIEF
Robert W. Wood

MANAGING EDITOR
Michael Henaghan

COORDINATING EDITOR
Raghavendra Kaup

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The plan was for the new PLC to acquire Eaton in an all-stock reverse triangular merger. The transaction was expected to qualify as a reorganization described in Code Sec. 368(a)(2)(E). Under Code Sec. 361(c), Eaton would not recognize gain when it distributed shares of Eaton PLC to the holders of its stock.

Ordinarily, target shareholders in an all-stock merger escape taxation pursuant to Code Sec. 354(a). Here, however, U.S. shareholders of Eaton would be transferring their stock to a foreign corporation (Eaton PLC). That would activate Code Sec. 367(a)(1), which "turns off" the reorganization provisions that normally protect share transfers.

To turn the reorganization provisions back *on*, the Eaton shareholders would need to come within Reg. §1.367(a)-3(c)(1). It includes a very useful exception for qualifying transfers of stock or securities of U.S. corporations. Unfortunately, however, this exception does not apply if the shareholders of the U.S. corporation receive more than 50 percent of either the total voting power or the total stock value of the foreign acquirer. [Reg. §1.367(a)-3(c)(1)(i).]

Since they were getting 73 percent of Eaton PLC, Eaton's shareholders were out of luck. This was disclosed in Eaton and Cooper's joint proxy statement, which clearly stated that the inversion *would* be taxable to Eaton's shareholders. Undeterred, the shareholders approved the transaction, and the deal closed on November 30.

Collateral Consequences

Eaton accurately disclosed the *direct* tax consequences of the inversion for the company and its shareholders. But analysts also wanted to know about the possible *collateral* effects of the inversion. First of all, did the inversion signal a change in Eaton's strategic direction?

The combination with Cooper would do more than move Eaton's domicile to Ireland. Cooper was a major manufacturer of industrial electrical products, so the tie-up would shift Eaton's focus even further in that direction. Which is to say, even further *away* from the automotive business.

An analyst asked Eaton's CEO about this as soon as the deal was announced. Now that Eaton was "looking a lot more like an electrical company," should investors expect *more* changes to Eaton's portfolio? The CEO responded that the company did not anticipate, and it was certainly not actively planning, any substantial changes to its business lineup because of the transaction with Cooper.

A second analyst followed up with a more technical question. How might *tax* affect the company's divestiture options following the inversion? Specifically, would Eaton PLC be "precluded by any element of the tax structure of the deal to spin off the truck and auto [business] … at any time?"

From an investor's perspective, that seems like a fair question. A good answer would have been the explanation the CEO gave on a call two years *later* (July 29, 2014):

> [W]e are not able to do a tax-free spin of any business for five years post the acquisition date of the Cooper transaction and that limitation means that any spin would result in a very significant tax liability.

We will discuss how an inversion can create a tax problem for a subsequent spin-off in more detail below. For now, however, what matters is that the CEO did not say anything about it on May 21, 2012. The CEO just said that there was "nothing in the deal *per se* that would prevent us from taking portfolio moves. But we have no such plans."

Reading Between the (CEO) Lines

Here, the CEO was presumably distinguishing between (1) *legal* constraints created by the terms of the inversion transaction ("the deal *per se*") and (2) the merely *practical* constraint imposed by the company's reluctance to incur "a very significant tax liability" in a spin-off. The CEO relied on the same distinction shortly before the closing, when he said there was "nothing … in our deal structure or any of our covenants that … prevents us from making changes in our portfolio."

The CEO's statements were literally true. Whether his failure to mention the problem under Code Sec. 355 was *misleading* depends on other factors. The first to consider is whether his listeners understood that he was addressing only legal obligations, not practical tax considerations.

Wall Street analysts are experts at reading the corporate tea leaves and reporting the results to the investing public. They are a sophisticated bunch, so it seems likely that they would have picked up on the CEO's implicit distinction. Whether they were misled for *other* reasons is a different question.

Post-Closing Commentary

On May 21, 2013, about six months after the closing, the CEO responded to *another* question about the consequences of the inversion. Was there anything 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?"

This time, the CEO addressed his answer to tax. But he touched only obliquely, if at all, on the company's ability to implement "larger-scale divestitures":

> 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 ability to move cash around the world without paying U.S. corporate income tax was certainly a bonus. But how would that have affected Eaton PLC's ability to do a major divestiture without adverse tax consequences? At most, it would have meant that there would have been cash available to pay the U.S. tax.

It was not until July 29, 2014, that the CEO finally "clarified" that Eaton PLC could not spin off any business for five years without incurring a "very significant" tax liability. The CEO did not explain why this was so, noting that "it's not a simple analysis." However, several outside advisors had corroborated Eaton PLC's analysis, so the company was "very certain" that it was correct.

Could the difficulty of the spin-off analysis explain why it took the company over two years to disclose it? Not according to the CEO. He told the audience that the tax analysis was "not new knowledge, we've been well aware of this all along."

From the beginning, Eaton and Eaton PLC had been telling analysts and investors that they were happy with the current portfolio, and that they had no intention of divesting itself of any of its assets. Nevertheless, the disclosure that tax considerations would preclude any spin-offs until after November 30, 2017, triggered an immediate eight-percent drop in the company's stock price.

Defendants' Motion to Dismiss

On July 22, 2016, a class action was filed under SEC Rule 10b-5 on behalf of persons who had purchased shares of Eaton or Eaton PLC prior to the CEO's 2014 disclosure. The defendants were the CEO, the company, and the CFO. Not surprisingly, the suit focused on the defendants' failure to disclose that the inversion would have an adverse effect on the company's ability to do spin-offs under Code Sec. 355.

On February 13, 2017, the defendants moved to dismiss the complaint, on the ground that none of their alleged misrepresentations or omissions was actionable under Rule 10b-5. The rule makes it unlawful to make any untrue statement of a material fact in connection with the purchase or sale of a security. It is also unlawful to *omit* a material fact if that fact is "necessary in order to make the [other] statements made, in the light of the circumstances under which they were made, not misleading."

This did not look good for the CEO. His disclosure on July 29, 2014, acknowledged that his earlier statements about divestitures had omitted information that some analysts and investors would consider relevant. Even worse, he had omitted this information from his responses to questions *specifically* asking how inversion-related tax issues might limit the company's strategic options.

The District Court, however, saw the matter completely differently. The court viewed the plaintiffs as narrowly focused on whether a spin-off of the automotive business would have been a taxable transaction. But the company had repeatedly stated that it had no plans to divest itself of the automotive business, so the District Court thought the tax issue was moot.

The court thought that was enough to establish that the defendants' failure to disclose the problem under Code Sec. 355 was *not* actionable under Rule 10b-5:

> [T]he theoretical tax consequences of a hypothetical transaction that was never planned and never occurred are not material, and the defendants were under no duty to disclose them.

Complaint dismissed.

What the CEO *Really* Disclosed

The District Court's formulation is rhetorically effective, but does it square with what actually happened? If the information that the CEO disclosed on July 29, 2014, was not material, why did Eaton PLC's stock price immediately drop by eight percent? The sudden loss of $3 billion in market capitalization is at least a hint that there was *something* of interest in the previously undisclosed information.

The market was not reacting to the news that a *planned* spin-off of the automotive business would be taxable. After all, Eaton PLC had denied any plans to dispose of the automotive business. In that case, did the stock price drop in response to the news that a "hypothetical transaction that was never planned and never occurred" would have been (hypothetically) taxable?

That sounds pretty far-fetched. So, one has to suspect that the District Court misconceived what was at stake. The case was about more than some analysts' idle curiosity.

Even if we focus exclusively on the automotive business, we should recognize that the company's disclaimer of any intention to sell or spin off those assets was hardly a binding commitment. As fiduciaries, corporate managers have not only the right, but also the duty, to change their minds as circumstances warrant. Management's present intentions are important, but analysts and the market are always looking down the road.

The CEO's disclosure could have been significant because it established that there could be no tax-free spin-off for five years, *even if conditions changed*. The CEO appears to have understood this well enough. Although he continued to emphasize that the company had no intention of doing a spin-off, he still thought it was important to "make it clear … that it's not simply an issue of will, it's also an issue of some very technical [tax] issues at this point."

We should also look beyond the automotive business. The inversion prevented Eaton PLC from spinning off *any* business for five years. Even if the fate of the automotive business was foremost in Wall Street's mind, the information disclosed by the CEO had broader implications.

Consider the issue from the perspective of a reasonable investor in a publicly traded conglomerate. Is it plausible that this investor would not have cared that the inversion would render Eaton PLC ineligible to use Code Sec. 355 for five years? If so, why did the company's stock price drop when the CEO disclosed the tax problem and its strategic consequences?

No Duty to Disclose?

The materiality of information, *per se*, does not create a duty to disclose. A corporation does not have to make a fact public simply because "a reasonable investor would very much like to know that fact." [*In re Time Warner Inc. Sec. Litig.*, CA-2, 9 F3d 259, 267 (1993).]

However, if a corporation chooses to comment on a matter, it has a "duty to be both accurate and complete." [*Cairoli v. Citibank, N.A.*, CA-2, 295 F3d 312, 331 (2002).] That can create an obligation to disclose facts that might otherwise have been left unstated. [*See In re Bristol Myers Squibb Co. Sec. Litig.*, DC-NY, 586 FSupp2d 148, 160 (2008) ("an entirely truthful statement may provide a basis for liability if material omissions related to the content of the statement make it … materially misleading").]

The CEO's pre-disclosure statements were responses to questions asking whether the inversion had imposed any tax-related constraints on Eaton PLC's ability to implement various strategic options, including divestitures. If the CEO had simply declined to address that topic, he could have kept mum about the collateral consequences of the inversion.

Once the topic was on the table, however, the CEO could not give a misleading *half* answer. His statement that Eaton PLC did not intend to modify its existing portfolio was apparently true. But it incorrectly suggested that any future spin-off was (as the CEO later put it) simply "an issue of will."

Similarly, the CEO's observation that the new "tax structure" had made it easier for the company to move cash around was true. But it, too, had the potential to lead analysts astray.

Without additional disclosure, the statement invited listeners to conclude, incorrectly, that the inversion had *not* imposed any tax-related limitations worth mentioning.

The Post-Inversion Tax Problem

The District Court's opinion in *Eaton* does not explain why the 2012 inversion had an adverse impact on Eaton PLC's ability to do tax-free spin-offs. The main pleadings also avoid getting into specifics. As the CEO said, it's not a simple analysis.

Code Sec. 355 bristles with technical requirements, any one of which can cause a spin-off to go down like the *Hindenburg*. In the case of inversions, the problem appears to be the "active business" requirement of Code Sec. 355(b)(1). A spin-off can qualify for tax-free treatment only if both the controlled corporation and the distributing corporation (or its subsidiaries) are engaged in the active conduct of a trade or business immediately following the distribution of the stock of the controlled corporation.

The goal of the active-business requirement is to prevent tax-free distributions of stock in corporations that are basically pools of liquid assets. If a corporation wants to distribute excess cash to its shareholders, it should declare a dividend. [*See* Donald P. Board, *Clarifying Devices and Active Businesses Under Code Sec. 355*, THE M&A TAX REPORT (Jan. 2017).]

A corporation could evade the active-business requirement by using its excess cash to *purchase* an active trade or business. It could then drop the new assets into a subsidiary and distribute its shares in a tax-free spin-off. The shareholders could then convert the shares or the assets back into cash as needed. [*See* H.R. Rep. No. 2543, 83d Cong., 2d Sess. 37 (1954).]

Five Long Years

To discourage this maneuver, Code Sec. 355 disregards any trade or business that was *purchased* in the past five years. [*See* Code Sec. 355(b)(2)(C) and 355(b)(2)(D).] As a technical matter, this is implemented by disqualifying a trade or business if it was acquired in a transaction in which *gain or loss was recognized*, in whole or in part.

The inversion chickens are finally coming home to roost. In 2012, Eaton's shareholders exchanged their stock of the U.S. corporation for more than 50-percent ownership of its new foreign parent. As noted above, this put the shareholders outside the protection of the reorganization provisions. [*See* Code Sec. 367(a)(1); Reg. §1.367(a)3(c)(1)(i).]

Eaton PLC therefore acquired the trades or businesses conducted by Eaton and its subsidiaries in a transaction in which gain or loss *was* recognized. Under a literal reading of Code Sec. 355(b)(2)(C) and (D), the acquired trades or business could not be used to satisfy the active-business requirement. Hence, they would not support a tax-free spin-off for five years following the inversion.

An Accidental Limitation?

The long-standing purpose of the five-year requirement is to prevent corporations from undermining the active-business requirement of Code Sec. 355(b)(1). A corporation that does not want to pay taxable dividends can use its excess cash to purchase a trade or business. The five-year rule prevents the corporation from spinning off the new business, tax-free, under Code Sec. 355(a).

Code Sec. 355(b)(2)(C) and (D), however, do not refer directly to the *purchase* of a trade or business. Instead, these provisions operate by disqualifying trades or businesses acquired in transactions in which gain or loss was recognized. This generally gets the job done, but it leaves at least a theoretical gap.

Suppose that Corporation A wants to purchase and immediately spin off a $10 million business owned by Corporation B. Corporation B's basis in the business is $10,265,402. Corporation A could avoid the five-year requirement by agreeing to purchase the business for $10,265,402, with whatever post-closing adjustments might be necessary to ensure that Corporation B would have zero gain or loss from the sale.

In that case, Corporation B would literally not recognize either gain or loss from the taxable sale. Reg. §1.355-3(b)(4)(i) was added to fill this gap in the five-year rule. Even if a trade or business is acquired without the recognition of gain or loss, it will still not satisfy the five-year requirement unless Corporation A's basis derives, in whole in or in part, from Corporation B's basis.

Inversions raise a different question. Under Code Sec. 367, U.S. shareholders recognize gain or loss in an inversion, so Code Sec. 355(b)(2)(C) and (D) literally apply to the trades or business acquired by the new foreign parent. But does applying the five-year limitation to the new foreign parent advance the purpose of the rule?

In an inversion, the new foreign parent acquires control of a U.S. corporation that is conducting one or more trades or businesses, either directly or through its subsidiaries. But if the foreign parent is issuing *stock*, it is not using the acquisition of the U.S. corporation as a device to convert its excess cash into a trade or business. So this does not look like a situation to which the five-year rule should apply.

Under Code Sec. 367, however, the shareholders of the U.S. corporation must recognize gain or loss because they are acquiring more than 50-percent ownership of the new foreign parent. But requiring the shareholders to recognize gain or loss in a stock-for-stock exchange does not convert the acquisition into a cash purchase of the U.S. corporation's stock or its underlying trades or businesses.

This invites questions. Assuming that there is a five-year embargo on spin-offs following an inversion, does it have any real basis in the policies underlying Code Sec. 355(b)(2)(C) and (D)? For all its practical significance, could this limitation simply be an accidental product of the inexact drafting of those provisions?

Conclusion

Eaton PLC seems to have dodged a bullet this time. With any luck, however, the Second Circuit will have a chance to weigh in on whether the CEO's failure to disclose the collateral consequences of the inversion was immaterial for purposes of Rule 10b-5. In the meantime, maybe somebody can explain why the CEO didn't avoid the whole mess by simply telling analysts that the inversion would interfere with the company's ability to do tax-free spin-offs.