Fallout Continues from AbbVie's Failed Inversion

By Donald P. Board • Wood LLP

Back in October 2014, big pharma's AbbVie, Inc. announced that it was backing out of its planned inversion with Ireland-based Shire Plc. It's been nearly three years, but the tax and securities law consequences of AbbVie's abrupt departure from the $54 billion deal remain unsettled.

AbbVie pulled the plug just a few weeks after the IRS released Notice 2014-52 [IRB 2014-42, 712 (Sept. 22, 2014)]. The Notice warned would-be inverters that they should expect new regulations cutting back on the U.S. tax benefits of their transactions. The regulations would apply retroactively to the date of the Notice, so there was no way for AbbVie and Shire to slip their deal under the wire.

When it announced that the deal was off, AbbVie blamed the IRS. AbbVie accused the IRS—quite accurately—of trying "to destroy the financial benefit of these types of transactions."

Acquisition agreements often allow the parties to walk away if there is an unfavorable change in the tax treatment of the transaction. AbbVie's agreement with Shire did not. So, AbbVie's decision to cancel cost it a whopping $1.64 billion reverse termination fee. Ouch!

As if that outsized fee weren't bad enough, the IRS wants to treat the payment as a *capital loss* under Code Sec. 1234A. If that sticks, AbbVie will need to generate some impressive capital gains if it wants to deduct its $1.64 billion expenditure. [*See* FSA 20163701F (Sept. 9, 2016), *discussed in* Donald P. Board, *Breakup Fees, Capitalization and Code Sec. 1234A*, THE M&A TAX REPORT (April 2017).]

Rule 10b-5, Round 1

When the inversion imploded, Shire's stock price dropped by 27 percent in a single day. Disappointed Shire shareholders filed a federal class action against AbbVie and its CEO, Richard Gonzalez, on November 25, 2014. The suit, *Rubinstein et al. v. Gonzalez and AbbVie, Inc.* [No. 1:14-cv-09465 (N.D. Ill.)], originally alleged that AbbVie and Mr. Gonzalez made seven false or misleading statements emphasizing the strategic benefits of the transaction while downplaying the critical role of taxes.

The *Rubinstein* plaintiffs demanded damages for violations of SEC Rule 10b-5. As they saw it, AbbVie's and Mr. Gonzalez's statements concealed the fact that tax savings were "the make-or-break reason" for the inversion. As a result, the market underestimated the risk that a change in U.S. tax law would sink the deal. The plaintiffs purchased Shire stock at a wrongfully inflated price.

In 2015, AbbVie and Mr. Gonzalez moved to dismiss the complaint for failing to meet the heightened pleading requirements of the Private Securities Litigation Reform Act of 1995 ("PSLRA"). Under PSLRA, the plaintiffs in an action under Rule 10b-5 must set forth with particularity the factual basis for their claims that the defendant's statements were misleading. [*See* 15 USC §78u-4(b)(1).] The defendant can have the suit dismissed if the facts alleged do not support a "reasonable belief" that the statements were misleading. [*Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, CA-7, 437 F3d 588, 596, *vacated and remanded*, SCt, 551 US 308 (2007).]

AbbVie's press release had made no bones about the fact that it was cancelling the deal in response to Notice 2014-52. So, the company could not deny that tax savings had been a "make-or-break reason" for the acquisition.

The plaintiffs pointed out that Mr. Gonzalez had told Wall Street analysts—and hence the market—that tax savings were "not the primary rationale" for the deal. AbbVie, he said, "would not be doing [the deal] just for the tax impact." The company's withdrawal following the IRS Notice proved that Mr. Gonzalez's statements had been misleading.

The District Court disagreed. Even if AbbVie had intended *not* to close the deal if it lost the tax benefits of the inversion, this only showed that the expected tax savings were a *necessary condition* to the transaction. As a matter of logic, it did not follow that tax savings had been the "primary rationale" for the deal. Nor did it mean that AbbVie would have done the transaction "just for the tax impact."

The District Court concluded that the plaintiffs had failed to allege facts supporting a reasonable belief that Mr. Gonzalez's statements had been misleading. The court assumed that, because those statements had been literally true, they were not misleading. It attached little, if any, importance to the possibility that the statements could have been misleading based on the conversational context in which they were made.

Mr. Gonzalez had been meeting with analysts to discuss the inversion. They repeatedly asked what AbbVie would do if something like Notice 2014-52 came down the pike. Mr. Gonzalez responded with positive-sounding statements about the non-tax rationale for the deal.

The fact that the CEO did not address the analysts' actual inquiry did not trouble the District Court. As long as Mr. Gonzalez's statements were *true*, the conversational context was not his problem. It was up to the analysts to figure out what his statements did—or did *not*—logically entail for the question they had posed. [*See* Donald P. Board, *Tax Inversions, Strategic Benefits and Rule 10b-5*, THE M&A TAX REPORT (Oct. 2016).]

On March 29, 2016, the court dismissed the complaint for failing to meet PSLRA's enhanced pleading requirements. The dismissal was without prejudice, so the *Rubinstein* plaintiffs amended their complaint and tried again.

Rule 10b-5, Round 2

AbbVie and Mr. Gonzalez responded to the amended complaint with another motion to dismiss. On March 10, 2017, the District Court denied the motion. A portion of the original suit is moving forward.

The plaintiffs made no progress with their contention that Mr. Gonzalez's statements to the analysts had been misleading. So, those claims were axed. What kept the plaintiffs' case alive were some statements that Mr. Gonzalez made in a letter to Shire's *employees*.

"Dear Shire Colleagues"

The IRS released Notice 2014-52 on Monday, September 22, 2014. AbbVie's board of directors did not withdraw its recommendation of the transaction until October 15. In the interim, the deal seemed to be moving ahead.

During the week of September 22, Mr. Gonzalez met with Shire employees at the company's offices outside Boston. He also attended an "Integration Team Planning Kickoff Meeting" with AbbVie and Shire employees in Chicago. There is no indication that Mr. Gonzalez said anything about the implications of Notice 2014-52 for the pending deal.

On September 29, Mr. Gonzalez sent a thank-you note to Shire's employees, whom he addressed as his "Dear Shire Colleagues." The subject line of the letter was "An Inspiring Visit." AbbVie filed a copy with the SEC.

The inspired CEO reported that he could "already see many shared traits and values" in the employees of the two companies. He then told them that he was (1) "more confident

than ever about the potential of our combined organizations," and (2) "more energized than ever about our two companies coming together."

Looking ahead, Mr. Gonzalez told Shire's employees:

> We have a very busy few months ahead as we work on integration planning. It's more important than ever to keep focused on our business priorities. Meeting our objectives as individual companies will only make our combined organization that much stronger.

He then thanked the Shire employees for their "continued support and commitment," adding that he looked forward to working with them much more closely "in the near future."

PSLRA and Reckless Disregard

The District Court conceded that the plaintiffs had alleged facts supporting a reasonable belief that Mr. Gonzalez's letter was misleading. However, PSLRA's heightened pleading requirements also apply to Rule 10b-5's *scienter* requirement. The plaintiff must state with particularity facts giving rise to "a strong inference" that the defendant acted with an actionable state of mind. [15 USC §78u-4(b)(2).]

The plaintiff need not show the defendant *intended* to deceive anybody. The Circuits that have considered the question have all concluded that it is enough that the defendant acted with *reckless disregard* for the risk that its statements might mislead investors. [*See, e.g., SEC v. Bauer*, CA-7, 723 F3d 758, 775 ("reckless disregard for the truth").]

The District Court thought it obvious that AbbVie would already have been thinking about ditching the deal in the week following the Notice. The court also pointed out that an AbbVie director had said that Mr. Gonzalez sent the letter to "calm Shire employee unrest."

The District Court concluded that these facts called into question whether Mr. Gonzalez had really been "more energized" and "more confident" than ever, or had merely been pretending to be so in order to pacify Shire's employees. The plaintiffs therefore satisfied PSLRA's requirement that they allege facts supporting "a strong inference" that Mr. Gonzalez had acted with reckless disregard for the risk of misleading investors.

"Energized" About What?

The *Rubinstein* plaintiffs have survived two motions to dismiss. That is hardly nothing, but how will they fare on the merits? They will certainly contend that Mr. Gonzalez's statements to the Shire employees were recklessly optimistic, if not outright deceptive.

AbbVie, on the other hand, may argue that the statements were not so cut and dried. Mr. Gonzalez said he was more confident than ever about "the potential of our combined organizations." That committed him to the proposition that AbbVie and Shire, *if combined*, had a lot of potential. He did not actually say he was more confident than ever that the two companies *would* be combined.

Well, what about Mr. Gonzalez's statement that he was "more energized than ever about our two companies coming together"? That could certainly mean he was energized about the *fact* that the two companies were about to be combined. But the statement could just mean that he was energized by the *prospect* that they *might* come together.

A Question of Price?

It would be hard to defend Mr. Gonzalez's statements if he had believed that the acquisition was *dead*. But the facts on the table hardly show that AbbVie had given up on the deal. Why, after all, would Mr. Gonzalez have visited Shire's offices, met with the integration task force in Chicago, and sent an encouraging letter to Shire's employees, if he did *not* think the combination still might happen?

AbbVie certainly understood that Notice 2014-52 had fundamentally altered the tax consequences of the planned inversion. But that would not necessarily have killed the deal if Shire had been willing to renegotiate the price to reflect the reduced tax benefits. As AbbVie stated in its press release announcing the deal's demise, the Notice meant that "the transaction was no longer in the best interests of stockholders *at the agreed upon valuation*."

At this stage in the litigation, we do not know what AbbVie and Shire were doing between September 22 and October 15. But what if it turns out that two companies were engaged in intense, if ultimately unsuccessful, negotiations to complete the inversion at a lower price? In that case, Mr. Gonzalez's statement that he

was "more energized than ever about our two companies coming together" could have accurately described his determination to close the deal *despite* the change in U.S. tax law.

The District Court, looking for evidence of *scienter*, found it significant that Mr. Gonzalez may have written his September 29 letter to "calm Shire employee unrest." But why would Mr. Gonzalez have cared about calming Shire employees unless he thought the deal might still happen? Similarly, why would AbbVie have been focused on integration planning if it did not believe that the acquisition might close despite Notice 2014-52?

The plaintiffs contend that AbbVie was simply trying to delay paying Shire the $1.64 billion termination fee. Perhaps, but how much would a three-week delay have been worth? Assuming an interest rate at 4.5 percent (AbbVie's 20-year bond rate), the charade would have saved the company less than $5 million. To the giants in this deal, that's pocket change.

Of course, even if AbbVie was ardently negotiating with Shire to restructure the deal, that would not have given Mr. Gonzalez license to tell the public whatever he wanted. If the chance of closing was only five percent, he could not claim it was 95 percent. But given the ambiguities in Mr. Gonzalez's statements about how confident and energized he was, there is room to argue about where he placed himself on that spectrum.

What's Next?

Rubinstein now moves on to discovery. It will be interesting to learn what Mr. Gonzalez and other managers were actually thinking and doing following the release of Notice 2014-52. But some AbbVie shareholders are not waiting to find out.

On May 4, 2017, a derivative action was filed against Mr. Gonzalez and certain directors in the Delaware Court of Chancery. [*Ellis v. Gonzalez et al.*, No. 2017-0342.] The suit alleges violations of the securities laws and seeks damages relating to (1) the $1.64 billion termination fee and (2) AbbVie's gigantic potential liability to the Shire shareholders in the *Rubinstein* class action. Stay tuned.

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