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The M&A Tax Report

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Tax Inversions, Strategic Benefits and Rule 10b-5

By Donald P. Board • Wood LLP

Anyone who reads the voluminous package inserts that come with prescriptions—or who actually listens to drug ads on TV—has been thoroughly warned. Manufacturers routinely disclose a dizzying list of contraindications, warnings, side effects and adverse reactions. One might get the impression that pharmaceutical companies just can't help sharing.

But shift the focus to big pharma M & A and it's a very different story. Consider the recent decision of the U.S. District Court in *Rubinstein et al. v. Gonzalez and AbbVie, Inc.* [No. 1:14-cv-09465 (N.D. Ill.) (Mar. 29, 2016)]. In *Rubinstein*, disappointed stockholders of Shire Plc are suing AbbVie, Inc., and its CEO, Richard Gonzalez, for what they allegedly did *not* share about the role of taxes in AbbVie's failed inversion with Shire in 2014.

The *Rubinstein* decision shows us a company and its CEO trying to walk the fine line between saying too little and saying too much about the role of taxes in a politically controversial M & A transaction. The case also suggests that whether a statement or omission is "misleading" for purposes of SEC Rule 10b-5 may involve a subtler mix of truth, logic and context than the courts necessarily acknowledge.

Seven Statements or Omissions

The *Rubinstein* plaintiffs asserted that AbbVie and Mr. Gonzalez had violated Rule 10b-5. At issue were seven statements or omissions that emphasized the purported strategic benefits of the acquisition, while allegedly downplaying the importance of taxes.

The plaintiffs alleged that these statements or omissions were false and misleading because tax reduction was actually "the make-or-break reason for the merger." Nondisclosure of this fact caused the market to underestimate the risk that a change in the tax law would sink the deal.

The plaintiffs claimed they were injured because they bought Shire stock at an inflated market price, only to see it plummet 27 percent when AbbVie pulled the plug on the merger. AbbVie's failure to

ALSO IN THIS ISSUE

disclose the critical role of taxes was like omitting warnings about potential side effects. Yes, that rash should clear up, but your arm could fall off.

The defendants could not deny that taxes had killed the deal. AbbVie announced the merger on July 18, 2014, but terminated it on October 20. The company's press release pointed the corporate finger at IRS Notice 2014-52 [IRB 2014-42, 712], which had been made public on September 22.

Those unfriendly people over at the Treasury had fired a proverbial shot across the bow. They announced plans to issue more regulations to reduce the tax benefits of inversions. A month later, the deal was dead.

Of course, AbbVie and Mr. Gonzalez denied that any of their prior statements had been false or misleading. They moved to dismiss the complaint for failing to allege facts sufficient to support a reasonable belief that their conduct was actionable under Rule 10b-5. With one exception, the court agreed.

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What the Company Said

The year 2014 witnessed an unprecedented surge in inversions. This set off alarm bells at the Treasury and led some members of Congress to demand action to rein in these transactions. Just a week after AbbVie announced what would have been the largest inversion in history, President Obama charged that inverting corporations were "gaming the system."

Given the heated political atmosphere, AbbVie might not have wanted to make *too* much of all the taxes it would save by inverting. And why not let the world know about all the *non*-tax benefits of the merger, too?

AbbVie formulated a standard list of seven to 10 benefits it hoped to realize from the transaction. They were mostly strategic, but at least one was always taxes.

Considered one by one, the company's statements did not present much of a target under Rule 10b-5. The plaintiffs, however, argued that it was misleading to include taxes as just one item on a long list of benefits even if each benefit was accurately described. That is a charge that may make tax advisers feel flushed. If taxes were "the make-or-break reason for the merger," AbbVie had duty to say so.

The District Court disagreed. AbbVie had listed numerous potential benefits from the transaction, but that was *all* it had done. The company had not ranked the benefits. In addition, it had not stated that *any* of them was so important that taking it off the table would kill the deal.

Precisely because AbbVie had said so little, the court held there were no misleading statements for the company to "rectify" by disclosing that it would terminate the merger if the tax rules changed. This "less is more" analysis finds support in the Supreme Court's current approach to Rule 10b-5. [*See, e.g., Matrixx Initiatives, Inc. v. Siracusano*, SCt, 563 US 27, 45 (2011) ("Even with respect to information that a reasonable investor might consider material, companies can control what they have to disclose … by controlling what they say to the market.").]

CEO to Analysts

Mr. Gonzalez, unlike the company, could not limit himself to carefully worded written statements. In accordance with Wall Street custom, he had to meet with securities analysts and respond, live, to questions about the deal. Does anyone invite tax lawyers to these events?

Meetings with analysts are informal affairs, often conducted on the phone. Yet they play an important role in shaping the market's perception of a pending transaction. AbbVie filed a transcript of Mr. Gonzalez's call with the SEC.

J.P. Morgan's analyst led off by noting that there had been "a lot of noise coming out of Washington" about inversions. How had the company "thought about that risk" as it considered moving its tax domicile to the United Kingdom?

Mr. Gonzalez responded that "this transaction has a significant, both strategic and financial, rationale. *Tax is clearly a benefit, but it's not the primary rationale for this*."

And that "noise" coming out of Washington? Mr. Gonzalez treated it as a question about tax policy. He shared his opinion that the debate should be "shifted towards tax reform and making companies more competitive in the global economy that we operate in."

Credit Suisse's analyst tried next. He said he was "just trying to understand kind of how important the ex-US domiciling for tax purposes is to this deal." If the tax law changed, would AbbView be willing to pay Shire the breakup fee to terminate the transaction?

Mr. Gonzalez first cautioned that "we're somewhat limited in what we can say," referring to the U.K. Takeover Code. He continued:

> [T]his is a transaction that we believe has excellent strategic fit and has compelling financial impact well beyond the tax impact. *We would not be doing it if it was just for the tax impact*.

BMO Capital Market's representative raised an eyebrow on behalf of his fellow analysts. They were "somewhat surprised about your comments that tax is not the primary rationale for this deal … [T]hat does not seem to be the perception out there."

Mr. Gonzalez stayed on message, insisting that there were "opportunities for different kinds of synergies beyond tax."

Logically Impeccable?

The plaintiffs pounced on these statements. AbbVie's decision to terminate the transaction in response to Notice 2014-52 proved that taxes *had* been the "primary rationale" for the deal and that AbbVie *had* been doing it "just for the tax impact."

Logically, however, this does not follow. Suppose the deal would have been worth pursuing only if it produced at least $40 in benefits. Also assume that AbbVie expected operating synergies worth $30 and tax benefits worth $15.

The total benefits would have been $45, so the merger would have been a "go." The operating synergies ($30) would have been twice the expected tax benefits ($15). So wouldn't Mr. Gonzalez's statement that taxes were not the "primary rationale" have been correct?

It is also clear that taxes alone ($15) would not have produced the required $40 in benefits. Consequently, there would have been nothing inaccurate in Mr. Gonzalez's saying that AbbVie was not doing the deal "just for the tax impact."

What about the plaintiffs' ace in the hole—the fact that AbbVie had paid a large breakup fee to terminate the transaction in response to Notice 2014-52? Again, the logic is hard to follow.

Suppose the offending Notice had knocked the expected tax benefits down from $15 to $5. The total expected benefits would then have been just $35—not enough to justify completing the transaction even if canceling would have cost AbbVie a $3 termination fee.

My math may be diminutive, but you get the point. The fact that AbbVie canceled the merger only demonstrates that obtaining some amount of expected tax benefits was a *necessary* condition to moving ahead with the deal. And necessary is not necessarily sufficient.

A Matter of Context

The court held that Mr. Gonzalez's responses were not actionable under Rule 10b-5. Saying that taxes were not the "primary" reason for the deal was not the same as saying taxes were "immaterial" or "unimportant."

Beyond this, the District Court accused the plaintiffs of "ignor[ing] the context" of Mr. Gonzalez's statements. The CEO, the court observed, had accurately described the tax benefits. Moreover, his comments on the debate in Washington had made it clear that he thought they were important.

Context is indeed critical. Rule 10b-5(b) declares it unlawful "to omit to state a material fact necessary in order to make the statements made, *in light of the circumstances in which they were made*, not misleading." But what were the circumstances in which the CEO made his disputed statements?

The District Court focused primarily on Mr. Gonzalez's other statements. But if a court is going to take a holistic approach, should it limit itself to just one side of the conversation?

Mr. Gonzalez was not talking to himself, after all. He was responding to questions from analysts seeking information to help them (and investors) evaluate the deal. And they were looking specifically for information about how the deal and the company would be affected by changes to the inversion rules.

Everyone on the call *knew* what the analysts were trying to find out. Mr. Gonzalez responded to their questions with a series of true statements. However, he did not really *answer* their questions, in the sense of addressing the issue that was on the analysts' minds.

There are conversational contexts in which accurate statements can be problematic. Suppose that Smith owns both a Lexus and a Ford. If Fred asks Smith whether she owns a Ford or a Lexus and Smith says "I own a Ford," her reply is true. However, it is clearly uncooperative, because what Fred *really* wants to know is what *cars* Smith owns.

Smith's true but uncooperative reply may also be misleading. Whether it is or not depends on whether Fred believes that Smith is answering cooperatively. In a normal conversation, cooperation is generally assumed.

Thus, in most contexts, replying "I own a Ford" invites Fred to draw the false conclusion that Smith does *not* own a Lexus. Smith's uncooperative reply would be misleading, despite being true. One might even infer that Smith *intends* to mislead trusting Fred.

What about the analysts? Did they really believe that Mr. Gonzalez would respond cooperatively to their questions about the importance of taxes? That seems improbable. Even in the best of times, a CEO is unlikely to declare publicly that tax savings are the "primary rationale" for a transaction, much less that the company is doing a deal "just for the tax impact."

Then add to the stew the considerable political controversy that was swirling around AbbVie's planned inversion. Within that messy vortex, it seems quite unrealistic to expect such an admission, even in response to a direct question.

It is also significant that Mr. Gonzalez told the analysts that he was "somewhat limited" in what he could say. The U.K. Takeover Code may or may not have imposed a limitation on his ability to address the U.S. tax risks. But warning about limitations, whether real or imagined, signaled that the Q & A session was *not* a normal conversation. So think twice before assuming cooperation.

One of the analysts professed surprise that Mr. Gonzalez was denying that taxes were the primary rationale for the deal. The analyst was presumably irritated by the CEO's refusal to cooperate. But it seems unlikely that he or anyone else on the call didn't know the score.

Conclusion

The District Court was probably right to conclude that Mr. Gonzalez's responses were not misleading under the circumstances in which they were made. However, its rationale missed the mark. The court focused on whether the statements were *true*.

That's not a bad start, of course. But even a true statement ("I own a Ford") can be misleading. It depends on the conversational context. This includes not only what is being asked, but also whether the normal expectation of cooperation applies.

Taking such considerations into account does not fit with the traditional rhetoric of the securities laws. If a company or its CEO speaks on a topic, candor is officially the order of the day. As *Rubinstein* suggests, however, a court may accept something less than complete frankness if the speaker's statements were literally true and the context indicates that the omissions were unlikely to mislead.

Be careful out there.