Key Takeaways

Skadden

Lessons Learned From Tax-Related Whistleblower Litigation and Shareholder Actions

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On March 8, 2017, Skadden hosted a webinar titled "Lessons Learned From Tax-Related Whistleblower Litigation and Shareholder Actions." The Skadden panelists were tax partners Nathaniel Carden and Armando Gomez, and litigation partner Peter Morrison.

Overview

Mr. Carden opened with a brief overview of how whistleblower litigation and shareholder actions work and two specific contexts in which these issues have shown up recently: reporting (specifically on Forms 1099 and 1098), and M&A transactions and tax planning.

Whistleblower Litigation

Mr. Gomez explained that whistleblowers are people who report potentially illegal activities that occur within an organization. These people can be employees, suppliers, contractors, clients, competitors or anyone who becomes aware of potentially illicit activity by virtue of their connection to the company. The government has an interest in incentivizing whistleblowers to come forward as a way of encouraging companies to comply with the law and has historically relied on whistleblowers, he said. Such incentives have also led plaintiffs' lawyers to help whistleblowers navigate the provisions available to those who come forward.

Mr. Gomez pointed out that the Internal Revenue Service (IRS) whistleblower program has a long history that dates back to the Civil War. In 1867, Congress enacted legislation that allowed for discretionary awards to whistleblowers who came forward to report individuals or companies violating revenue laws. This discretionary basis for awards continued until the Tax Relief and Health Care Act of 2006 was passed, which made key changes to Section 7623 of the Internal Revenue Code (IRC). Most significantly, the awards are now mandatory for any whistleblower who provides information that leads to the collection of money from a taxpayer. The statute provides awards of between 15 percent and 30 percent for information that directly leads to IRS collections, and 10 percent for information that merely corroborates other information the IRS already had. Mr. Gomez pointed out that the amount awarded includes taxes, penalties, interest and even proceeds collected under other provisions of the U.S. Code (such as under Title 18 for failure to disclose foreign bank accounts).

Mr. Gomez then discussed the history of the updated Section 7623 program and details of the recently released fiscal year 2016 IRS whistleblower office report. In the last year, the IRS reported over 13,000 new whistleblower claims and closed over 21,000 claims. Since 2006, it has collected over $3.4 billion and awarded whistleblowers over $465 million.

Mr. Gomez explained the differences in protections provided under the IRS whistleblower program in Section 7623 compared to other whistleblower provisions such as in the Dodd-Frank Act. Most notably, there are no specific protections against retaliation under the IRS whistleblower program. In 2016, the Treasury Department proposed legislation asking Congress to provide for protections, but so far such measures have failed to materialize. Other provisions that whistleblowers commonly rely on are various state False Claims Acts. While the federal False Claims Act expressly bars anything that relates to the IRC, some states, such as New York and Illinois, do permit tax-related matters to proceed under their False Claims Acts.

Derivative Actions

Mr. Morrison noted that in addition to whistleblower and *qui tam* lawsuits, there has also been a recent uptick in tax-related derivative and class action litigation claims. He agreed with Mr. Gomez that plaintiffs' lawyers are looking closely at tax issues, which has led to an increase in litigation activity in this area. Derivative actions, he explained, are where a shareholder steps into the shoes of the corporation and sues on behalf of the corporation, often against the officers and directors for breach of fiduciary duty. Recently, there has been an increase in derivative lawsuits where board members are alleged to have breached their fiduciary duties — of either care or loyalty — or engaged in corporate waste as a result of tax planning pursuits that were later challenged or did not result in anticipated tax benefits. In several such cases, the corporation's share price drops once it is revealed that the corporation's tax planning has been challenged or that anticipated benefits would not be realized, resulting in parallel securities and derivative litigation.

Mr. Morrison provided a number of examples of tax-related derivative actions. For instance, he described *Noel v. Meyers et al.*, a derivative suit filed in the U.S. District Court for the District of Massachusetts in 2013, where a shareholder alleged breach of fiduciary duty, waste of corporate assets and unjust enrichment, based on the defendants' allegedly false statement that the corporation's sale of one of its trust certificates would result in substantial tax benefits. When the IRS questioned the company's actions and shareholders learned that the allegedly promised benefits might not materialize, the corporation's stock price dropped. The derivative suit challenging the board's actions, as well as a securities lawsuit, *Smith v. The First Marblehead Corp. et al.*, 55 F. Supp. 3d 223 (D. Mass. 2014), followed.

Mr. Morrison also described the case captioned *Louisiana Municipal Police Employees' Retirement System vs. Hesse et al.*, 962 F. Supp. 2d 576 (S.D.N.Y. 2013), which was brought following the announcement of a $300 million New York state False Claims Act penalty resulting from the corporation's tax policy. Mr. Morrison noted that civil litigation often follows public announcements that a regulator is taking action or that a company cannot claim a certain benefit.

Class Actions

Mr. Morrison noted that there has also been an uptick in class actions in recent years concerning tax issues. Securities class action claims arise under the Securities Act of 1933 (for misstatements in registration statements or prospectuses), the Securities Exchange Act of 1934 (most often under Section 10(b), the general anti-fraud provision of the federal securities laws) and state law.

Examples of tax-related class actions include *Smith v. The First Marblehead Corp. et al.*, 55 F. Supp. 3d 223 (D. Mass. 2014), a case that arose from the same transaction as the *Noel* derivative action discussed above; and *Hays v. Walgreen et al.*, (N.D. Ill./7th Cir. 204), where plaintiffs alleged that the corporation failed to divulge necessary information regarding its decision not to use a tax inversion structure for a proposed merger. Mr. Morrison noted that *Hays* was particularly interesting because it is an example of plaintiffs' lawyers pursuing lawsuits against companies that allegedly omit information about tax strategies in which they ultimately do not engage. Such an approach may put companies in the difficult position of being susceptible to lawsuits either way — shareholders will either accuse the corporation of acting too aggressively or not aggressively enough.

Reporting and Withholding Cases

Mr. Morrison said shareholders, taxpayers and counsel are now closely examining companies' tax reporting obligations and are bringing claims based on state law for misrepresentation, fraud, breach of fiduciary duty and even breach of contract.

Form 1098 Reporting. In a number of cases, plaintiff borrowers have alleged that they overpaid their taxes because mortgage originators or servicers failed to report on their Form 1098 plaintiffs' payments of unpaid or deferred mortgage interest, which allegedly were added to the principal as part of their mortgage contract. Mr. Morrison said several class actions have been brought concerning this issue. The fact that plaintiffs are suing the originators and servicers rather than seeking a refund from the IRS marks a noticeable shift in the last few years.

Form 1099 Reporting. Mr. Morrison next described theories of claims arising under Form 1099 reporting. Form 1099-DIV reporting claims are based on the allegation that companies are mischaracterizing distributions to shareholders as dividends, rather than returns of capital, due to allegedly miscalculating earnings and profits (E&P) for tax purposes. Here, too, plaintiff shareholders have elected to sue the companies in which they invested rather than seek a refund from the IRS.

Mr. Carden added that in the case of Form 1099-DIV, as a matter of tax law, distributions are presumed to be made out of E&P unless the corporation can demonstrate otherwise. This creates challenges because shareholder claims mean that a company may not be able to rely on this simplifying convention in its shareholder reporting. Recent cases illustrate the need for companies to reconsider their standard approach to E&P and ensure their practices have been vetted in both their finance and legal departments.

Tax Planning

Mr. Carden said shareholder and whistleblower actions are arising from situations once considered part of traditional M&A and tax planning, and not subject to shareholder litigation. Mr. Carden believes the increase in such actions, based on public and financial statements as well as shareholder expectations, is due to heightened public and media scrutiny of corporate tax practices.

Mr. Carden boiled the claims down to three types: alleged misrepresentations about the tax motivations of a planned transaction; alleged misrepresentations about the tax impact of a planned transaction; and allegations that shareholders in cross-border merger situations were improperly made to recognize gain on their shares, even in a stock deal.

Key Issues

Mr. Carden then discussed key issues that arise in tax planning-related litigation.

Corporate vs. Shareholder Interests in Tax Treatment. In the case of cross-border mergers involving a U.S. public corporation, regardless of management team retention or which party was bigger, the non-U.S. public company often ends up being the company, which typically subjects the U.S. shareholders to gain. In these scenarios, some shareholders, particularly longterm holders that do not want to pay tax on transactions that they don't receive cash for, will bring suit claiming the transaction was improperly structured as a taxable transaction.

Forecasting Impact. Companies, meanwhile, will make statements about their motivations and what the structure will ultimately be, or will represent what they expect the transaction to do from a tax-planning standpoint regarding the financial impact on subsequent transactions. Company caveats and about forward-looking statements do not necessarily deter plaintiffs' bar cases. Plaintiffs have argued that even forward-looking statements by management regarding the relative importance of tax benefits to a transaction are misleading if they are overstated or understated. Mr. Carden recommended that management carefully review such statements and ensure they accurately reflect the company's thoughts without overpromising with respect to future consequences.

Non-U.S. Tax Liability Potentially at Issue in U.S. Cases. Mr. Carden explained that even though shareholder litigation cases are brought in U.S. court, they may not be limited to issues of U.S. tax liability. As an example, Mr. Carden discussed Silver Wheaton Corp., a Canadian precious metals streaming company, which plaintiffs allege did not disclose its Canadian transfer pricing tax risks, resulting in U.S. litigation over securities claims.

Federal vs. State Court. Mr. Carden noted that in many circumstances in which claims are brought under a state False Claims Act, defendants have been unsuccessful in their attempts to remove to federal court, even though the federal tax principles may be the basis for state tax claims. Mr. Morrison added that the Form 1099 cases discussed earlier were similarly brought in state court and that removal was unsuccessful.

Privilege Concerns. Mr. Carden noted that certain information about the company's operations may be highly confidential and companies may expect to enjoy privilege. He pointed out the different treatment of some privileges in shareholder litigation may mean that such information loses its privilege. Most notably, for U.S. federal tax purposes, IRC Section 7525 provides privilege for federally authorized tax practitioners who are not acting as attorneys. In ordinary interactions with the IRS, this privilege prevails, but it is explicitly confined to tax matters.

Key Takeaways

Whistleblower Actions

Mr. Gomez said company information must be properly stored and compartmentalized to prevent unnecessary access. Furthermore, it is essential that companies not create a culture of secrecy, as employees in such environments may opt to raise their concerns outside the company without first bringing them up the chain internally. Employers also should review their confidentiality and post-employment agreements.

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In the event that a company has had its information misappropriated, it is critical that the company act quickly and bring an action to compel the return of the documents. If the information is privileged, the company could disqualify plaintiff's counsel, Mr. Gomez said.

Mr. Gomez reiterated that the most important preventative measure a company can take is fostering a culture that encourages employees to come forward with any concerns, and having a formal mechanism in place for them to do so, such as an anonymous hotline or an open door policy with management. Companies should also follow up with employees who raise concerns, either to inform them that they are taking steps to address a valid concern or, if they deem there was no merit to the issue, to explain why. Next steps for addressing valid concerns could include self-reporting to the IRS, Securities and Exchange Commission or Department of Justice, which can help mitigate damage. But Mr. Gomez explained that such voluntary disclosures require complete disclosure, including reporting the involvement of any culpable individuals.

Companies should document and handle employee performance issues with diligence in order to maintain a record should a dissatisfied employee try to make accusations about the company's tax positions, Mr. Gomez said. Best practices include documenting performance issues and conducting exit interviews with departing employees.

Shareholder Cases

Mr. Morrison emphasized the need for coordination between tax departments and legal teams, and encouraged companies to pay particular attention to their public disclosure concerning tax issues. Companies can reduce risk of disclosure claims by opting for more balanced, as opposed to aggressive, language around the potential to achieve certain tax benefits and the scope and impact of such benefits.

Mr. Carden concluded the webinar by highlighting the importance of company counsel understanding their company's key tax positions. If management can understand the risks ahead of time, they can help position the company should it be challenged in court.

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