CtW Investment Group

March 9, 2017

David L. Calhoun
Board Chairman
Caterpillar Inc.
100 NE Adams Street
Peoria IL 61629

Dear Mr. Calhoun,

The coordinated investigations by multiple federal agencies on the facilities of Caterpillar Inc. (the "Company"), regarding its Swiss subsidiary known as "CSARL," call into question the Company's ability to oversee risk and threaten confidence in the Company's internal compliance and Audit Committee functions and raise concerns over the accuracy of the Company's stated profitability.

To reassure Company investors that the board is able to critically evaluate the potential regulatory, financial, and reputational costs related to their decisions, the board should:

- Prior to the Company's 2017 annual meeting, establish a special committee of independent directors not currently or previously involved in approving the Company's tax strategy to investigate, evaluate, and disclose changes to reduce noncompliance and risks related to the Company's tax scheme. If the Company is unable to establish a special committee, it should reconstitute the Audit Committee, whose tenure spans much of the misconduct described below.
- Replace PricewaterhouseCoopers ("PWC") who both developed the tax avoidance scheme and is currently responsible for the Company's external auditing.
- Amend the Company's clawback policy to enable the board to recoup executive compensation in the event of conduct that results in reputational or financial harm to the Company, as outlined in the shareholder proposal that we filed for inclusion in the Company's 2017 proxy statement.

The *New York Times* recently reported that the Company is currently being investigated for tax fraud by the Internal Revenue Service ("IRS"), Justice Department, Commerce Department and Federal Deposit Insurance Corporation, a highly unusual allegation for a large multinational company and one that could result in heavy fines or penalties.[1] According to an IRS investigation in 2013 and Senate investigation in 2014, the Company's executives and directors participated in improper and potentially illegal conduct by engaging in an offshore tax strategy, avoiding the payment of nearly $2.4 billion in taxes, and failing to

[1] *Caterpillar Is Accused in Report to Federal Investigators of Tax Fraud*, available at https://www.nytimes.com/2017/03/07/business/caterpillar-tax-fraud.html?smid=nytcore-ipad-share&smprod=nytcore-ipad

disclose to the Securities and Exchange Commission ("SEC") and investors the status of IRS' findings against these arrangements.

Taken as whole, the federal investigations regarding both the Company's offshore tax structure and the possibility of the Company's intentional circumvention of U.S. tax laws to enhance the Company's share price call into question the Audit Committee's ability to oversee Company risk. Moreover, these mounting allegations regarding the Company's tax strategy suggest, at a minimum, a lack of aggressive board oversight that has resulted in significant reputational costs to the Company for which the board does not appear to have made timely or appropriate remedies.

The CtW Investment Group works with pension funds sponsored by unions affiliated with Change to Win, a federation of unions representing nearly 5.5 million members, to enhance long term shareholder value through active ownership. These funds invest over $250 billion in the global capital markets and are substantial investors of the Company. In the last two years, we previously engaged with the Company's board with regards to its executive compensation plan.

The Board Should Form a Special Committee to Investigate the Board's Risk Oversight Management or Reconstitute the Audit Committee.

Despite the fact that the IRS and Senate investigated the Company almost four years ago, it is not clear what the Audit Committee has done to address the risks involved in the Company's off shore tax strategy. Directors Dickinson, Muilenberg and Osborn sat on the Audit Committee during the IRS investigations and Senate hearing related to CSARL and the redistribution of Company profits to the Swiss tax haven. Further, Audit Committee Chair Osborn has sat on the board effectively since the inception of the tax strategy over 16 years. The audit committee should explain what actions they have taken to mitigate the tax strategy risks.

On the day of the raid alone, Caterpillar's stock price fell by 4.6%, and shareholders filed a class action law suit on March 3, 2017 alleging the Company made false statements in relation to the tax strategy in its disclosures to the SEC. The Company's use of its offshore subsidiary also jeopardizes the Company's status as a federal contractor that has received over $500 million in contracts from the U.S. government in the last three years.[2] The members of the Audit Committee were presumably aware of the legal and financial risks posed by the offshore tax strategy, and yet to the best of shareholders' knowledge, there is no indication that the Committee acted to mitigate these risks. Reiterating our concerns to you outlined in our letter from December 2016, the board should either form an independent special committee to disclose the remedial actions taken by the Company or reconstitute the Audit Committee with new independent members who can take a fresh look at the Company's tax strategies.

The Audit Committee has Failed to Manage PWC's Conflict of Interest.

We are particularly worried over the apparent conflicts of interest resulting from the continued role of PWC as the Company's external auditor for over 80 years.[3] PWC created the very offshore tax strategy

[2] USA Spending, https://www.usaspending.gov/Pages/AdvancedSearch.aspx?sub=y&ST=C&FY=2016,2015,2014&A=0&SS=USA&RN=Caterpillar

[3] Caterpillar's Offshore Strategy, Permanent Subcommittee of Investigations, U.S. Senate, Majority Staff Report ("PSI Report"), p. 41.

that it currently evaluates as part of the annual audit process. Furthermore, the Company relied on former employees of PWC to lead the Company's tax department. David Burritt was an auditor with PWC prior to joining the Company. He was the Company's Chief Accounting officer from 2002 to 2007, and Chief Financial Officer from 2005 to 2010. Robin Beran, the Company's Chief Tax Officer until 2015 (who provided allegedly false testimony to the Senate[4]) was also a former PWC partner.

The conflict of interest presented by PWC and the shared personnel between the two entities is especially concerning in light of the high degree of regulatory scrutiny that the Company's tax strategy has received, even prior to the federal raid on March 3rd. The Audit Committee's failure to replace PWC as the Company auditor raises serious questions as to the Committee's ability to recognize real conflicts of interest that endanger the quality of the Company's auditing and financial statements. As expeditiously as possible, the Audit Committee should replace PWC with an independent external auditor that is unrelated to the development and implementation of the offshore tax scheme.

The Company Should Strengthen Executive Pay Accountability.

Documentation uncovered during the Senate investigation show executives were well aware of the risks associated with the tax scheme, but nonetheless agreed to the arrangement, improperly reporting profits and enriching themselves in the process through their equity compensation awards. For example, internal company documents estimated an annual tax benefit of $250 - $300 million per year and $0.40 - $0.48 profits per share.[5] Given the reputational cost to the Company as a result of its tax strategy and potential misconduct by Company executives, the board should take immediate action to strengthen executive pay accountability by adopting the changes to the Company's clawback policy, as outlined in our shareholder proposal.

Conclusion

The Company is now faced with a serious challenge to its reputation as a long-standing American manufacturer; one that while not new, now poses an even greater risk to the Company's long term value. We urge the board to commit to the changes outlined above and encourage a dialogue with its shareholders as to how best to address the significant business risks facing the Company.

We would be happy to discuss our recommendations with you at your convenience. Please contact my colleague Tejal K. Patel at (202) 721-6079 to pursue such a discussion.

Thank you.

Dieter Waizenegger
Executive Director

[4] Hearing Before the Permanent Subcommittee on Investigations of the Committee on Homeland Security and Government Affairs, Caterpillar's Offshore Tax Strategy, p. 633, *available at* https://www.gpo.gov/fdsys/pkg/CHRG-113shrg89523/pdf/CHRG-113shrg89523.pdf

[5] PSI Report, p. 75.