Regulators Join in Event-Driven Securities Litigation: The SEC Files New Action Against Volkswagen

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In recent years, plaintiffs have increasingly filed securities litigation in response to reports of bad actions within companies. This phenomenon is known as "event-driven" securities litigation, with a claim generally based on the theory that the company must have known that it was committing bad acts and should have told its investors of the alleged misconduct. Commentators have pejoratively dubbed this the theory that "everything is securities fraud."

On March 14, the Securities and Exchange Commission ("SEC") joined this trend and filed suit against Volkswagen AG, alleging fraud in connection with offerings of the company's corporate and collateralized debt.

The SEC's civil suit against Volkswagen, two of its financing subsidiaries and its former CEO, Martin Winterkorn, was filed more than two years after Volkswagen admitted to criminal wrongdoing related to the use of software "defeat devices" to evade emissions tests of the company's diesel vehicles. The SEC alleges that Volkswagen made false statements related to its compliance with environmental regulations and omitted information regarding its use of "defeat devices" in connection with corporate debt offerings in 2014 and 2015. The SEC also alleges fraud in relation to a Volkswagen subsidiary's sponsorship during the same period of asset-backed securities ("ABS") that included the company's diesel vehicles as collateral. The SEC seeks injunctive relief, disgorgement, civil penalties and, in the case of Winterkorn, a bar from serving as an officer or director of a U.S. public company.

According to Volkswagen, the SEC informed the company that it issued its formal order of investigation in January 2017, the same month that Volkswagen agreed to plead guilty and enter into civil settlement agreements with the Department of Justice ("DOJ"), the Environmental Protection Agency ("EPA") and U.S. Customs and Border Protection. The resolution with the EPA was itself the third in recent years regarding Volkswagen's diesel car emissions, and the $4.3 billion in criminal and civil penalties imposed by the agencies in January 2017 was only a fraction of what Volkswagen has agreed with U.S. regulators to pay related to its diesel cars sold in the U.S.[1]

The SEC's suit is notable for several reasons.

First, the SEC's suit continues a trend in event-driven securities litigation. Much has been written lately regarding the increase in event-driven securities litigation in the private civil context.[2] The SEC's filing in this matter, which at its core originates not with financial statement or financial performance concerns, but with the discovery of alleged misrepresentations related to environmental standards, suggests that U.S.

[1] According to Volkswagen, the company has spent approximately €29 billion ($33 billion) in recent years related to its use of "defeat devices" in diesel vehicles, the majority of which has been related to U.S. enforcement proceedings.

[2] *See, e.g.*, John C. Coffee, Jr., *Securities Litigation in 2017: "It Was the Best of Times, It Was the Worst of Times"*, THE CLS BLUE SKY BLOG (Mar. 19, 2018) ("Increasingly, an adverse event will trigger a securities class action . . . ."), http://clsbluesky.law.columbia.edu/2018/03/19/securities-litigation-in-2017-it-was-the-best-of-times-it-was-the-worst-of-times/.

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regulators, like private civil plaintiffs' counsel, may be willing to attempt to apply the securities laws in less traditional areas.

Second, the suit serves as a reminder that U.S. regulatory resolutions related to alleged corporate misconduct—even those seemingly coordinated with multiple agencies and involving significant financial disbursements—can prove difficult to manage collectively and often have a significant tail. The SEC's suit is distinct in certain respects from the prior proceedings involving Volkswagen. Notably, the SEC alleges that Winterkorn was aware of the use of "defeat devices" more than seven years before the DOJ has alleged in its indictment of Winterkorn and several other Volkswagen executives. However, the underlying allegations regarding diesel emissions in the SEC's suit relate to the same facts that Volkswagen has previously admitted, and the SEC's ABS allegations substantially overlap with those of the DOJ's prior civil settlement. Despite recent efforts by U.S. authorities to avoid staggered enforcement proceedings against companies based on the same alleged misconduct,[3] the SEC's suit demonstrates the possibility that companies may face continued securities enforcement liability even years after reaching resolutions with U.S. regulators. For companies facing enforcement actions, it remains vitally important to coordinate interactions across multiple regulators and jurisdictions.

Third, the SEC's suit demonstrates the agency's willingness to bring enforcement actions against foreign companies with no securities listed in the U.S. The SEC alleges that the Volkswagen bonds at issue were sold in private placements under SEC Rule 144A to U.S. institutional investors.[4] The suit against Volkswagen evinces the SEC's efforts to enforce the securities laws against foreign companies, even when the alleged wrongdoing is arguably centered outside the United States.

Fourth, the SEC's suit raises questions about the enforcement of U.S. securities laws in cases involving performing corporate debt obligations. The SEC does not allege any default related to the $8.3 billion in debt that Volkswagen issued or the nearly $5 billion in ABS that its subsidiary sponsored. To the contrary, Volkswagen responded to the SEC's suit with a statement that all principal and interest related to the debt at issue had been paid. According to the SEC, however, investors in Volkswagen's corporate bonds were harmed by assuming more risk of default than they were compensated for through bond coupon payments. The SEC alleges that Volkswagen fraudulently obtained "hundreds of millions of dollars in benefit" from U.S. investors, citing declines in bond values after Volkswagen's use of "defeat devices" became public and rating agencies cut the credit ratings for certain of the company's bonds.[5] At this preliminary stage, the SEC has not set forth its calculation of Volkswagen's alleged benefits. However, the suit raises questions about the appropriate method of ascertaining benefits from allegedly fraudulent bond or other debt offerings, especially where there has been no default on the performance of the debt.

There is also a noteworthy contrast between the SEC's theory of the case in this matter and the ability of many bondholders to recoup against Volkswagen directly. Essentially, at least at this stage, the SEC suggests that Volkswagen was able to achieve more favorable terms on its debt or was able to offer the debt it offered because of its alleged misrepresentations and/or concealment of information about emissions. In many ways, the SEC's theory is akin to the "fraud-on-the-market" and "fraud created the market" theories that certain holders of the bonds at issue in the SEC's suit asserted against Volkswagen

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[3] *See, e.g.*, Rod Rosenstein, Deputy Attorney Gen., Remarks to the New York City Bar White Collar Crime Institute (May 9, 2018) (encouraging DOJ attorneys "to coordinate with other federal, state, local, and foreign enforcement authorities seeking to resolve a case with a company for the same misconduct").

[4] According to the SEC, certain ABS sponsored by a Volkswagen subsidiary were also sold in public offerings under Regulation AB.

[5] The SEC also alleges that, after Volkswagen's use of "defeat devices" in its diesel vehicles came to light, the company did not conduct any bond offerings or public ABS offerings in the U.S. for more than three years.

in private civil litigation. Last year, the United States District Court in the Northern District of California rejected these theories as insufficient based on the Court's analysis of the market for Volkswagen's corporate debt, allowing the case to continue only to the extent that bondholders are able to offer proof that investors directly relied on the alleged misstatements.[6] Unlike private civil litigants, however, the SEC need not plead reliance, and may bring enforcement actions based on alleged material misstatements or omissions, irrespective of whether reliance can be presumed based on the market price for the securities.[7] Moreover, to the extent the SEC is able to point to a market price drop in the secondary market for the bonds to prove that the alleged misstatements and omissions related to emissions were material to the value of the bonds in the hands of bondholders, rather than direct evidence that Volkswagen would not be able to keep current on its principal and interest payments, market price fluctuations in the debt markets may start to be viewed more similarly to market price fluctuations in the equity markets. In any event, the SEC's litigation requirements are, in important ways, less difficult to satisfy than those of the bondholders themselves.

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[6] *See In re Volkswagen "Clean Diesel" Mktg., Sales Practices, & Prod. Liab. Litig.*, 328 F. Supp. 3d 963, 968–71 (N.D. Cal. 2018) (rejecting "fraud-on-the-market" and "fraud created the market" theories, but allowing claims to proceed based on theory of direct reliance).

[7] *See, e.g.*, *United States v. Vilar*, 729 F.3d 62, 88–89 (2d Cir. 2013) ("[W]hen the government (as opposed to a private plaintiff) brings a civil or criminal action under Section 10(b) and Rule 10b-5, it need only prove, in addition to scienter, materiality, meaning a substantial likelihood that a reasonable investor would find the omission or misrepresentation important in making an investment decision, and not actual reliance.").

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