



VOLKSWAGEN – ERRORS AND EMISSIONS

2016 will mark 80 years of Volkswagen car manufacturing – the “people’s car” was launched in 1936 at the Berlin motor show.

There would have been little expectation that in 2015 Volkswagen’s proud history would be marred by the biggest scandal ever to hit the automotive manufacturing industry. The implications are global and far reaching: whether you insure or regulate the Volkswagen group, work at a Volkswagen affiliate, own or distribute Volkswagen brand cars you are affected. Even if you do not fall into any of those categories – Volkswagen is one of the largest automotive suppliers globally and the admission that it caused emissions data to be falsified, rather than manufacture environmentally compliant cars, has misled consumers and governments and is environmentally a matter of public health, particularly in relation to respiratory diseases.

This scandal dwarfs previous automotive settlements. Last year Toyota paid US\$1.2 million in fines concerning a sudden acceleration problem, and General Motors some US\$900 million, due to an ignition switch defect. Volkswagen itself is no stranger to scandal having been embroiled in bribery and corruption issues in the mid-nineties when some executives were jailed and significantly, in 1973, Volkswagen of America paid US\$120,000 in fines owing to the use of defeat devices designed to disable pollution control systems in four models.

From a regulatory perspective this bears the hallmark of a Volkswagen forex/libor scandal. Questions will be asked in respect of regulators generally – what did they know and when?

Volkswagen also owns SEAT, Audi, Skoda and premium brands such as Lamborghini, Bugatti, Bentley and Porsche. The emissions issue appears only to relate to diesel models in the Audi, VW, Skoda and SEAT brands.

Volkswagen has set aside approximately £4.7 billion to cover recall costs and efforts to restore trust in its products. This does not take into account fines, liability to affected parties, or the cost of defending litigation.

Fines in the US alone could exceed US\$18 billion based on a maximum environmental fine of US\$37,500 per non-compliant car manufactured since 2008.

At its low point, shares had fallen by 35% – some US\$15 billion off the total share value, before rallying to some 20% down on the second day of the scandal.



It is not possible to quantify in monetary terms the damage to Volkswagen's reputation.

Volkswagen has vowed to file criminal complaints against those responsible. Prosecutors in Wolfsburg, Volkswagen's home town, are also considering bringing complaints. The New York Attorney General has promised an investigation. Surely it is only a matter of time before the Department of Justice in the US is involved.

The German Vice Chancellor has offered the American authorities the German Government's complete support. Investigations have been launched as far away as Korea, and Switzerland has already prohibited the sale of certain Volkswagen models. Volkswagen's financial services arm – as big as General Motors' equivalent – is said to be under review by the European Central Bank. Hundreds of thousands of cars globally are now subject to recall. Truly a scandal of global proportions.

The facts

On 23 September 2015 Martin Winterkorn resigned as CEO of Volkswagen.

Earlier that week, apparently as a result of the American authorities (the Washington based Environmental Protection Agency and California Air Resources Board) threatening to withhold approval for certain Volkswagen 2016 models, Volkswagen admitted that some 11 million cars – originally said to be exclusively in the US but now admitted to be in Europe too – had been fitted with so called "defeat" devices. Crudely, this software, installed in the car's engine management system, identifies when the car is subject to an emissions test and responds by temporarily lowering emissions. The key emission is nitrogen oxide (NOx) – the defeat device disguises the fact that the cars are emitting up to 40 times the level allowed in the US where standards are most stringent. It has been suggested that nitrogen oxide is a pollutant that

leads to thousands of deaths each year. In the UK alone half of the 500,000 cars sold last year contained a diesel engine.

Implications

The main exposures are set out below, but will differ from country to country.

Shareholders/Investors

Permanent impairment of the share price

Volkswagen AG has the following shares in issue:

- Preference shares: 180,642,042
- Ordinary shares: 295,089,818

Volkswagen shares are listed on various German exchanges (Berlin, Dusseldorf, Frankfurt, Hamburg, Hanover, Munich and Stuttgart) and outside Germany in Basle, Geneva, Zurich, Luxembourg and in New York where there are two ADR programmes.

Volkswagen has admitted that deception occurred. Share and bond holders in Volkswagen and investors in, for example, funds who have invested in Volkswagen may be entitled to bring a claim based on the permanent impairment/diminution of the share price, which has a knock-on impact on the convertible bond price. Volkswagen is traditionally a conservative stock and no doubt a major constituent of investment portfolios worldwide. BAFin, the German financial regulator, is already reviewing whether Volkswagen released market sensitive information in a timely manner.

Whilst there are complex jurisdictional and legal arguments, such a claim is theoretically possible. The claim would be based on the valuation of the company immediately preceding the revelation of the deception. Market conditions would need to be considered and other car manufacturers would be used as comparators. Given such a sharp drop and the reason for it, it is unlikely that the company's value will return to pre-scandal levels in the near term, or at all. In any jurisdiction, consideration should be given to the statements made by

directors and officers of the company, including the management board, and the results, in particular, of any criminal investigations. To involve 11 million cars it is likely that the software was installed on the production line. The wider and higher up the company that the knowledge of this deception goes, the more significant the liability that will attach to the Volkswagen Group.

In the US such an action would be founded on the racketeering (RICO) legislation. This is the most appropriate mechanism for claiming a permanent diminution in a company's share price. It also allows for the trebling of damages in both civil and criminal cases. A recent case saw a publicly reported settlement of US\$100 million in New Jersey. Such a case may be appropriate for alternative litigation funding.

Derivative action

Alternatively, there is scope for a claim brought by a shareholder in the name of, and for the benefit of, the company for a wrong against the company which the company is unable, or unwilling, through its directors to pursue itself. That said, such a claim is for the benefit of the company and will only benefit a shareholder indirectly to the extent the claim is successful and the share price increases as a result.

Insurance

It is likely that a substantial part of Volkswagen's directors' and officers' (D&O) and other liability insurance is underwritten or reinsured in the London insurance market. Zurich Insurance Group has confirmed that it leads a consortium providing €450 million of APO cover. Individual directors and officers will be the subject of regulatory and criminal investigations and will incur substantial defence costs. They will seek to recover these costs under D&O policies. Civil actions against directors will also trigger notification of claims under D&O and other liability policies. Insurers, reinsurers, and brokers need to be prepared. In the UK it is also



likely that disputes will arise in respect of warranty claims on diesel cars and insurers may seek to avoid the relevant policies for non-disclosure and misrepresentation. Where Volkswagen has insured against non-performance of finance agreements insurers may seek to avoid those policies. The risk that Volkswagen may ultimately be compelled to self insure may be very substantial.

Distributors

Distributors globally may also have substantial claims against Volkswagen in relation to loss of profit on cancelled contracts and liability incurred to customers for misrepresentation and loss in value. There is also scope for disputes between distributors and the Volkswagen Group if Volkswagen seeks to share liabilities imposed in fines against dealers or avoid paying warranty claims in full. Volkswagen cars may struggle to pass emissions tests. The Department of Transport in the UK will no doubt issue guidance in this regard given the potential for loss of revenue if cars are incorrectly banded for car tax purposes as a result of incorrect emissions data.

Car manufacturers

Although causation and valuation may be difficult, competitor car manufacturers may argue they suffered loss as consumers bought Volkswagen cars rather than their brands. A starting point could be the EU Misleading and Comparative Advertising Directive. Although in the UK there is currently no right of civil action by competitors against advertisers who have breached the implementing regulations, in other Member States, such as Germany, national legislation protecting consumers against unfair commercial practices may apply at least in part to marketing practices affecting businesses and that actions for damages are possible.

Consumers

There is no doubt that consumers along with investors will suffer most.

The allegations suggest a multi-layered deception. The misrepresentation of eco-credentials and other misrepresentations has a significant impact in that consumers were not sold the product as described. When marketing and selling, the car salesmen have no doubt promoted the cars as environmentally friendly and have referenced fuel savings linked to engine efficiency. It is possible that some of those claims are not true. Individual consumers now own a product which is almost certainly worth less than anticipated, which has a corollary effect on residual values where cars are subject to lease or similar arrangements – especially where a determinant of future value is a “balloon” payment. Car fleets have similar issues and, in addition to the reduction in fleet values, there may be increased tax charges as a result of increased emissions. Expect in England and elsewhere claims against dealers and class actions on behalf of individual consumers. Such claims are more straightforward in the UK as the Consumer Rights Act became law on 1 October 2015. Various class actions have already been launched in the US and threatened by consumer lawyers elsewhere. In Australia, the Trade Practices Act claims regime is a unique federal jurisdiction for foreigners who make misleading statements in Australia about their goods and services. Class actions in particular may be appropriate for alternative litigation funding.

How HFW can help

Material event management

Our team of specialists has many years of experience in handling the legal issues arising from major incidents, both in relation to physical and non physical damage events. Our material event management practice focuses on scenario identification and planning for material events and then implementing the plan. The foundation of this practice is corporate governance and the need for executives to identify and decide how to deal with risk. We can provide a one-stop crisis management service

for a client, which can include managing financial and regulatory exposures; brand protection; press and investor relations (including social media); issuing or defending proceedings and liaising with insurers and others.

We are particularly familiar with “bet the company” issues – members of our team have been instructed in cases where litigation was used to avert the sudden decline in a company’s share price as a result of a defamatory act, or to prevent mass staff walk outs intended to kill or cripple a company. In a case where allegations of data theft in excess of US\$2 billion were made to undermine a company, the resultant settlement was less than US\$1 million. We understand that for any company share price maintenance is key.

Material events frequently involve or are triggered by dawn raids by regulators or law enforcement authorities. We have helped numerous clients deal with raids or plan for them, including training and undertaking mock raids.

Reputation management

We can advise on the impact of social media and reputation protection for both companies and individuals. This includes analysis of governance and appropriate regulatory standards.

Directors and officers – defence

We can act for directors and officers to defend them in relation to regulatory and similar investigations and any litigation that follows.

Insurers

We regularly act for insurers and reinsurers of D&O and other liability policies. The insurance sector recognises that specialist corporate and regulatory advice is a necessity in today’s competitive and diverse global markets.

Litigation funding

We can access alternative litigation funding sources in appropriate cases.



Information and communications management

We work closely with boards, company secretaries and senior management and their media advisers to ensure that information flows are managed effectively to mitigate legal risk and comply with regulatory requirements. For publicly traded companies, material

events may cause share price volatility, with prices moving in response to each development in the public domain. Careful judgement must be made about the handling of information and its disclosure for regulatory or other purposes, to ensure insider dealing and market abuse issues do not compound existing difficulties.

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