Simpson Thacher

Regulatory and Enforcement Alert

Key Takeaways From the SEC's Lawsuit Against Volkswagen

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On March 14, the Securities and Exchange Commission charged Volkswagen AG and its former CEO, Martin Winterkorn, with defrauding U.S. investors in connection with the company's diesel emissions scandal. The SEC's case, which comes more than two years after the company resolved criminal and civil investigations by the Department of Justice by pleading guilty to felony charges and paying $4.3 billion in fines, alleges that Volkswagen made a series of misstatements while issuing over $13 billion in bonds and asset-backed securities ("ABS") in 2014 and 2015. During that period, according to the SEC complaint, Winterkorn and other senior Volkswagen executives knew that the company had used a "defeat device" to enable it to sell over 500,000 vehicles in the United States that exceeded legal emissions limits. The SEC claims that Volkswagen's failure to disclose that operational misconduct meant that investors paid more for the debt securities than they otherwise would have, allowing the company to raise money at more favorable rates.

Key Takeaways

The action highlights a number of recent trends in securities enforcement and litigation: (1) an increasing tendency to frame alleged operational misconduct as a violation of the securities laws; (2) the importance of individual accountability in the SEC's enforcement program; (3) the SEC's expansive view of materiality in respect of debt securities; and (4) the willingness of the SEC to bring an enforcement action related to a company's failure to disclose alleged operational issues even when other arms of the government have pursued charges (and obtained significant remedies) related to those issues.

A Securities-Law Approach to Alleged Operational Misconduct

The SEC's action reflects the growing trend of securities-related enforcement activity against public companies predicated not on traditional accounting or financial reporting misstatements, but on the alleged failure of those companies to disclose operational issues, including risk management failures. For example,

in recent months, DOJ and the SEC have reportedly launched investigations into whether Apple violated the federal securities laws by failing to disclose its alleged use of software that slowed down operating systems on older iPhone models. The New York Attorney General last year brought an action against ExxonMobil, alleging that the company failed to disclose the extent to which its operations could be affected by climate change. Such actions are also commonplace in private litigation. Among other recent examples, investors have brought securities class action lawsuits against CBS for failing to disclose allegations of sexual misconduct against its former CEO, Leslie Moonves, and against Facebook for not telling investors that Cambridge Analytica had improperly obtained information about millions of Facebook users. In none of these matters did the alleged operational misconduct appear to have been directed principally at investors.

This trend underscores that potential liability under federal and state securities laws should be a chapter in every company's crisis management "playbook," irrespective of the subject matter of the alleged wrongdoing. Notably, the specter of such liability has a long tail. The SEC action involving Volkswagen comes several years after the Environmental Protection Agency first publicly alleged the company's use of its defeat device.

The SEC's Focus on Individual Accountability

The SEC decision to charge Winterkorn along with the company is in keeping with one of the pillars of the agency's Enforcement program: individual accountability. Even though Winterkorn was criminally charged by DOJ last year, the SEC determined to sue him as well, alleging that he knew of the company's emissions-related misconduct seven years before DOJ alleged that he did. The SEC is seeking both a civil money penalty and a permanent officer-and-director bar against the former CEO.

The SEC's Expansive View of Materiality in Respect of Debt Securities

In bringing its action, the SEC would appear to have adopted an expansive view of materiality. According to a statement made by Volkswagen following the SEC's filing, the bonds at issue did not default, and all holders of the bonds and ABS have received timely payments of interest and principal. (Volkswagen's common stock was not traded in the U.S., so the SEC's claims are limited to the debt securities sold in the U.S.) The SEC nevertheless alleges that purchasers of the securities (most, if not all, of whom were institutional investors) were harmed because they paid more than they would have had they known that Volkswagen vehicles did not meet U.S. emissions standards. In other words, had investors known the "truth" about the company's use of defeat devices, they would have secured higher interest rates for their bonds and ABS. From the SEC's perspective, the materiality of a company's alleged misstatements, at least in relation to its debt securities, does not turn on the performance of those securities.

The Willingness of the SEC to Pursue Charges Related to Operational Issues Even When Other Government Agencies Have Brought Their Own Charges

In light of the significant criminal and civil penalties previously imposed on Volkswagen in the United States, Volkswagen reportedly said that the SEC was "piling on to try to extract more from the company." Indeed, among the actions the company resolved with DOJ in 2017, one involved a civil claim under FIRREA relating to the company's issuance of ABS bought by federally-insured financial institutions. In this regard, while the SEC was careful to acknowledge in its complaint that Volkswagen had previously paid billions of dollars in fines to resolve claims brought by DOJ, the EPA and state attorneys general, and many billions of dollars more in restitution to resolve consumer class action claims, it also emphasized that the company "has never repaid the hundreds of millions of benefit it fraudulently obtained from the sale of its corporate bonds and ABS." (The securities class action claims brought by investors in those debt securities are still pending.)

The lesson here is that a company looking for global peace with the government in connection with operational issues should not dismiss the possibility of an SEC enforcement action simply because the company has been pursued by—or even has settled with—other arms of the government in connection with the same issues. Instead, the company and its advisors must make strategic decisions in defense of government enforcement actions and private litigation with the expectation that the SEC will bring its own case relating to the failure to disclose those issues.

For further information about this Alert, please contact one of the following authors or your regular Simpson Thacher contact.

NEW YORK CITY

Brooke E. Cucinella
+1-212-455-3070
brooke.cucinella@stblaw.com

Stephen M. Cutler
+1-212-455-2773
stephen.cutler@stblaw.com

Nicholas S. Goldin
+1-212-455-3685
ngoldin@stblaw.com

Joshua A. Levine
+1-212-455-7694
jlevine@stblaw.com

Jacob Lundqvist*
+1-212-455-3348
jacob.lundqvist@stblaw.com

**Not yet admitted*

Simpson Thacher Worldwide

UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston
600 Travis Street, Suite 5400
Houston, TX 77002
+1-713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
900 G Street, NW
Washington, D.C. 20001
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3901 China World Tower A
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Tokyo
Ark Hills Sengokuyama Mori Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino
Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000