



## Fraud

# Hedge Fund Holders of Short Positions in Volkswagen Sue Porsche and Two Top Executives for Fraud for Allegedly Lying about Porsche's Intention to Take over Volkswagen and Allegedly Manipulating the Supply of Porsche Stock

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On October 26, 2008, Porsche Automobil Holding SE (Porsche), a European public company and German automobile manufacturer, announced that it owned directly, or had the right under cash-settled options to purchase, 74.1% of Volkswagen's stock. Plaintiffs are a group of hedge funds that held short positions in Volkswagen AG (VW) stock on that date. VW's stock price immediately rose on the Porsche announcement. By the time Porsche went public with its VW holdings, plaintiffs' short positions equaled more than 13% of VW's outstanding shares. Because the German State of Lower Saxony controlled more than 20% of VW, only about 6% of VW shares were available for purchase on the open market to cover the plaintiffs' short positions. A dramatic "short squeeze" ensued as plaintiffs scrambled to cover their short positions. VW's stock price soared from around 200 Euros per share prior to the Porsche announcement to over 1,000 Euros per share at the height of the squeeze on October 28, 2008. Plaintiffs allege that, from as early as February 2008, Porsche lied and manipulated the market in a covert effort to accumulate sufficient options to take control of VW without paying a premium for control. They claim that, had Porsche revealed its true intentions in the months prior to October 26, 2008, the price of VW stock would have begun to rise sooner and they would not have shorted VW stock at all or would have done so at higher prices. They also allege that Porsche made billions in illicit profits by releasing some of its own VW shares for sale at the peak of the squeeze. We summarize the hedge funds' allegations and the events leading up to the dramatic October 2008 short squeeze. See *Elliott Associates, L.P., et al. v. Porsche Automobil Holding SE, f/k/a Dr. Ing. h.c. F. Porsche AG; Wendelin Wiedeking and Holger P. Haerter*, United States District Court, Southern District New York (10-CV-0532 (HB)(THK)).

## Background of the Action

Plaintiffs are a number of hedge funds that took short positions (or entered into the short side of security-based swap transactions) in Volkswagen AG (VW) stock during 2008. Defendant

Porsche began to purchase VW shares in 2005. Defendant Wendelin Wiedeking (Wiedeking) was Porsche's President and Chief Executive Officer. Defendant Holger P. Haerter (Haerter) was its Vice President of Finance.

A silent, but critical, player in the events leading up to the alleged fraud is the German State of Lower Saxony, where VW is based. That State owned over 20% of VW. As described below, that substantial position essentially prevented a hostile takeover of VW.

Porsche and VW had a longstanding business relationship. Porsche had acquired its initial stake in VW (and had continued to increase that stake over time) in part to prevent a hostile takeover of VW. The complaint alleges that Porsche first acquired a large block of VW shares in 2005 from a U.S. hedge fund. By early 2008, Porsche owned about 30% of VW stock.

According to the complaint, under German takeover laws, a company that acquires 75% of a target company's stock has the right to impose a "domination agreement" between acquirer and target. The domination agreement gives the acquiring company full control over the target – and its profits. However, in this case, the so-called "VW Law" in effect at that time increased the threshold for domination of VW to 80%. Because Lower Saxony owned more than 20% of VW, Porsche could never get control of VW without making a deal with Lower Saxony. The complaint alleges that Porsche expected the VW Law to be abolished by the European Court of Justice. If the takeover threshold were lowered from 80% to 75%, Porsche's effective control of 74.1% of VW's stock would put Porsche within easy striking distance of domination of VW.

## **Alleged Misrepresentations and Market Manipulation**

The crux of the complaint boils down to the following allegation:

"Porsche's statement that it would not raise its stake in VW to 75% was false. In fact, Porsche representatives held a secret meeting in Berlin on February 25, 2008, with a high-ranking officer of the Government of the State of Lower Saxony participating on behalf of Prime Minister Christian Wulff. As the German press first reported in May 2009, Porsche there stated its intention to implement a domination and profit transfer agreement, both of which require at least 75% ownership."

### **False Statements**

Notwithstanding Porsche's alleged intention to take over VW, the complaint highlights eight allegedly false statements by Porsche between February 25, 2008 and October 26, 2008, when it announced its 74.1% stake:

- March 4, 2008: Porsche announces its intent to acquire "majority shareholding" in VW to create an "automotive alliance."
- March 10, 2008: Porsche denies that it is seeking 75% of VW's shares and states that "the probability of acquiring the necessary shares from the free float [i.e., shares not owned by Lower Saxony] is very small indeed."
- May 5, 2008: A Porsche representative states that Porsche would obtain "more than 50% ownership in VW" either outright or through options, but that it had no intention of increasing its stake to 75%.
- May 29, 2008: Porsche issues a statement that its VW stake would "be increased to over 50%."

- July 28, 2008: Haerter states that “We’re determined to cross the 51% threshold this year.”
- September 18, 2008: Porsche states that domination is “totally unrealistic.”
- October 2, 2008: Wiedeking does not rule out a future domination agreement, but states that it is a “purely theoretical option.”
- October 5, 2008: Wiedeking states that 75% is a long-term possibility, but “out of the question at present.”
- October 22, 2008: A Porsche representative states that Porsche has no intention of increasing its stake to “much beyond 51%.”

The case could potentially turn on precisely what those statements mean and whether, even if literally true, they were in fact misleading to a “reasonable investor.” For instance, Porsche’s insistence that it would not increase its stake to 75% was in fact true – at most, it had the right to acquire just over 74% of VW stock. Similarly, Porsche’s acquisition of 74% of VW was not literally inconsistent with its statements that it would acquire “majority shareholding” and “over 50%” of VW. However, the complaint argues repeatedly that those statements could only be reasonably interpreted to mean “slightly over” 50%, not as much as 74%.

## Market Manipulation

In addition to the allegedly false statements about Porsche’s intentions, plaintiffs claim that Porsche used options contracts and other derivatives to conceal the extent of its VW holdings, putting it in a position to “ambush the market once it had amassed control over enough shares.”

- Plaintiffs claim Porsche used derivatives to conceal its market activities. It is said to have disguised “physical options contracts,” which Porsche would have been under a duty to disclose to the market, as “cash settled options contracts,” which did not carry the same disclosure requirement.
- Porsche allegedly “parceled out” option contracts in small lots so that the counterparties to those contracts would not have the duty to disclose them. Plaintiffs point out that the counterparties to the options would likely have acquired VW shares to hedge the options. If they acquired sufficient shares, they would have to disclose that ownership, thereby alerting the market that someone had entered into a large derivatives position with that counterparty which would, in turn, allow the market to infer that a takeover of VW was in progress. See [“District Court Holds that Long Party to Total Return Equity Swap May be Deemed to have Beneficial Ownership of Hedge Shares Held by Swap Counterparty,”](#) Hedge Fund Law Report, Vol. 1, No. 14 (Jun. 19, 2008).

The alleged effect of Porsche’s false statements and manipulative options transactions was to decrease artificially the price of VW stock prior to Porsche’s October 26, 2008 announcement and to increase artificially VW’s price once Porsche’s actual position was revealed. This resulted in plaintiffs’ contracting to sell VW stock at artificially low prices prior to Porsche’s announcement and needing to cover those short positions at artificially high prices. According to the complaint, “No Plaintiff would have sold VW shares short had it known that Defendants intended to take over VW and that Porsche had already amassed a huge position in options, options that Porsche considered equivalent to shares it owned outright.”

The complaint also alleges that Porsche reaped huge profits as a result of the squeeze it created when it “released billions of Euros worth of shares into the short squeeze for its own profit.”

The complaint briefly mentions the fact that, at the time of the alleged misconduct, the 80% ownership threshold under the VW Law was still in effect, so that Porsche could not actually take over VW at that time. Also, implicit in the complaint is the notion that Lower Saxony would never sell any portion of its stake in VW on the open market.

## **Plaintiffs' Causes of Action**

Plaintiffs allege three separate federal securities fraud causes of action against all three defendants and a fourth cause of action for common law fraud against Porsche alone.

### **False Statements under Section 10(b) of the Securities and Exchange Act of 1934 (Exchange Act) and Rule 10b-5 thereunder**

Porsche is said to have intentionally sought to mislead plaintiffs into believing that it was not going to take over VW. Wiedeking and Haerter are alleged to have made false statements and to have controlled Porsche's dissemination of false and misleading information. The defendants' actions allegedly constitute a "fraud on the market" because plaintiffs "justifiably relied on the integrity of the market price for VW's shares."

### **Market Manipulation under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder**

Defendants alleged false statements and covert options transactions allegedly kept the price of VW's shares artificially low prior to the October 26, 2008 announcement and artificially high after that announcement. Plaintiffs reiterate their "fraud on the market" charge.

### **Violation of Section 20(a) of the Exchange Act**

Wiedeking and Haerter are alleged to be "controlling persons" of Porsche, who are therefore jointly and severally liable for Porsche's fraud.

### **Common Law Fraud**

Plaintiffs allege that the activities complained of also constitute common law fraud by Porsche.

## **Jurisdiction**

Because Porsche is a German company, and both Wiedeking and Haerter are German nationals based in Germany, plaintiffs must show that the district court has personal jurisdiction over them (i.e., the constitutional authority to assert the court's power over them and force them to defend the suit in the U.S.). Therefore, the complaint recites a laundry list of e-mail messages to, and conference calls with, various U.S. entities relating to Porsche's acquisition of VW stock to show that the defendants have sufficient "minimum contacts" with the United States to satisfy the Due Process Clause of the Fifth Amendment. It also recites more general contacts, such as Porsche's English language website and the fact that United States is Porsche's biggest market. Defendants Wiedeking and Haerter are alleged to have had contact with the U.S. primarily as directors of Porsche's U.S. subsidiaries and as persons who made various statements directed at U.S. investors.

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