26 September 2018

"DIESELGATE"

Volkswagen Litigation Update & Point of View

On September 10, 2018, hearings finally got underway at the Higher Regional Court of Braunschweig, in Germany, relating to claims of more than €9.5 billion in investor losses, from the nearly 40% stock drop in connection with the Volkswagen ("VW") AG "Diesel Scandal".

The "Diesel Scandal" became world news in September 2015, upon revelations that Volkswagen, for years, had installed so called "Cheat Devices" in hundreds of thousands of cars to circumvent environmental testing and regulations in the United States, and that VW would certainly face significant fines from the U.S. Environmental Protection Agency (EPA).

The lawsuits, by various investors and litigation coalitions, are consolidated under the German collective action procedures, known as "KapMuG"-a single institutional plaintiff and a single law firm. In this case, TILP Litigation Rechtsanwaltsgesellschaft mbH ("TILP"), was selected by the Court to represent all investors and coalitions at the proceedings in Braunschweig.

The proceedings can theoretically take many twists and turns, and any rulings by the Higher Regional Court in Braunschweig can be appealed to the German Federal Court, if the parties are not able to find a way to reach a settlement. If the parties cannot come to terms, the process could drag on for years in the German Courts, as the case can both be appealed to the Federal Court in matters of wrong doing and sent back to the original Lower Court in Braunschweig in matters of damages.

However, based on a number of factors, including take-away(s) from the first 3 full days of hearings (so far), it is very possible that the parties will be looking to explore the potential for reaching a settlement in the earlier or mid-term stages of the "KapMuG" process.

Understanding where this might go: There are several pre-hearing events, factors, information and good take away(s) from the first 3 days of hearings in Braunschweig that are worth paying attention to.

Pre-trial:

- On September 18, 2015, Volkswagen CEO Martin Winterkorn made his first announcement to the public regarding the Company being investigated by the EPA for installing emission engine management "cheat devices" in their diesel cars. On September 22, 2015, Winterkorn made an admission of guilt in a highly publicized public video apology stating, "I apologize sincerely to our customers and the regulatory agencies and the public for the misbehavior."

- Since Winterkorn's first announcement, VW has paid U.S. authorities $25 billion in fines, penalties and civil damages, including a $4.3 billion fine from the U.S. EPA and is subject to a number of consumer litigations, settlements and expensive buy-back and remedial programs, all together totaling more than $30 billion, thus far.

- In its 2017 Annual Report, the Company announced "in connection with the diesel issue," it had recorded "contingent liability provisions" for €3.4 billion related to investor securities litigation.

- In 2018, the Company settled USD $48 million for its ADR (American Depositary Receipts – trading 5 to 1 to the underlying shares). VW's sponsored ADR program and the underlying ADS securities, is very small and represents less than 2% of the total float of VW. VW predominantly trades "at home" on the XETRA exchange in Frankfurt.

- After squaring off the US settlement, the remaining provision for investor securities litigation is approximately €3.36 billion on the Company's financial statements. For all practical purposes, there is no other relevant litigation than the German litigation, to consider in this regard.

At the trial in the last two weeks:

- While nothing has been ruled on as of yet, it is worth noting that presiding judge Christian Jäde indicated that the allegations by the plaintiffs about Winterkorn's knowledge in 2007/2008, about the manipulation and his involvement in the technological developments at VW, were sufficient to place a burden of demonstration on the defendants to prove that former CEO Martin Winterkorn did not know about the manipulation. The judge cited a speech Winterkorn made in

Vienna about the prospects of the diesel technology in the U.S. market on April 25, 2008, saying that this suggested Winterkorn had at least looked into the details of the engines and engine development.

In terms of placing responsibility on the Company, it is also most likely adequate from a legal standpoint under German law, to show that the Company failed to exercise control over senior managers. It has pretty much been established, that senior managers were members of some of the Company's management committees, were well aware of what was happening, and directly involved in the diesel manipulation scheme.

The Courts already expressed their disposition relating to CEO Martin Winterkorn, indicating that they are unlikely to accept any kind of excuses or arguments from VW, regarding management not being aware or responsible for the acts of the Company.

- This litigation involves "securities law and tort law" and it "involves inflation losses and rescission losses".

  We believe the strongest claims and most significant outlook to recovery of damages, relates to inflation losses under the securities laws. These losses are much stronger in nature, in terms of actual book value losses or direct mark-to-market losses and portfolio write-downs. A debate over the class period(s) took place. For securities claims, it is probably safe to say that losses attributable to securities purchased after July 9, 2012 and forward are eligible.

  One can expect continued debating over the eligibility of various rescission claims under the tort law, securities laws, and their various class period(s). In the event of an early or mid-term settlement, we assume that a much higher ratio of damage awards will be allocated to inflation losses.

- Most interesting, the Court has already stated that it will discuss the issue of calculating damages during the next oral hearing in November 2018. According to TILP and other observers, this would normally occur after a ruling on "Attribution of Knowledge". It is hard to say why the Court will discuss damage calculations this early in the proceedings, but one can speculate, that by exploring how far apart the parties are in their view on damages, the Court might create a forum and provide an impetus to open the door for settlement discussions next year.

Looking at some of the above highlights and many other factors not listed here, it is possible that VW would consider a discounted early settlement versus continued long-term litigation over full damages, together with potential further discoveries and rulings of wrong doings.

In this regard, there are pragmatic minimum timing considerations. Under German Securities laws, the statute of limitation expires at the end of the 3rd year anniversary of the "bad news" disclosure. In the "Dieselgate" case, the disclosure was 18 September 2015, so the statute expires 31 December 2018.

It is costly to litigate in Germany and only those who actively have signed on to participate in litigation under the "KapMuG" proceedings can participate in a settlement or ultimate judgement. As only a subset of eligible investors have sued at this time, it makes sense for VW to await the expiration of the 31 December 2018 statute of limitation, before indicating their interest in entertaining any settlement discussions.

Discussions of any potential settlement and potential learned economics from any such discussions prior to the expiration of the statute of limitation, could inspire further lawsuits from investors that otherwise have been unwilling to invest time, reputation, or cost to join the collective action, considering the risks of an unknown litigation result.

After 31 December 2018, the door is permanently shut for the risk of any additional investors having success with starting further lawsuits in the matter and VW's exposure is capped off to the existing claims under the "KapMuG" proceedings at that time.

It is still possible to join the litigation via a last round up group coordinated by ISAF Management Company and maybe some other groups. In all events, we do not expect additional late investors to represent over a 10% addition to the existing claimants on file with the Court.

Meantime, the proceedings will continue for now. Over the coming months, TILP, plans to show the Court that VW management had knowledge of the cheat device as early as 2007 and executive management of Volkswagen made false representations about the "clean" diesel technologies, associated sales and financial forecasts to the capital markets. TILP will lean on VW's own financial, marketing and regulatory filings, and will try to implement documents provided by litigators in the recently settled securities fraud case in the United States. We expect these procedural and substantive matters to be adjudicated by an exchange of briefs and additionally by subsequent hearings scheduled in 2019.

Separately for your information, in July of this year, the Court of Braunschweig **ruled that Porsche SE**, be included in this proceeding as a co-defendant. The Porsche family is a controlling shareholder of Volkswagen and Porsche family members control the Volkswagen Supervisory Board. Nearly 52% of VW common stock is voted by Porsche.

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Point of View

Our objective is to provide basic information and research. However, we are asked all the time what we think. We do not provide legal advice, accounting advice or other forms of formal advice. We are happy to share our view, but it is only our view and others might disagree with our opinions or the facts.

What could, should and probably will happen!

If there ever was a situation where the stars and the planets perfectly align for a settlement, **this case is in position to be that settlement.**

Compared to other global corporate scandals like Enron, BP, or Petrobras, Volkswagen has largely owned up and not aggressively disputed its wrongdoings in public. The Company has moved swiftly to address fines and car owner remedial programs.

1. **Point One.** In the U.S., the company has already entered into a settlement with investors purchasing ADR securities on the NYSE. The NYSE ADRs (American Depositary Receipts) are directly linked to a small subset (ADS) of the underlying common and preferred shares outstanding in Germany. The pricing of Volkswagen on the NYSE and XETRA move together in real-time. So, in relative terms, the ”Dieselgate” impact to pricing and shareholder losses in US and Germany were the exact same. There should be no reason to treat the two classes of shareholders differently. Keep in mind only a small amount of ADRs’ trade in the US and trade in a ratio of 5 ADRs’ to one XETRA share (5:1).

   A very important related piece of information. According to Volkswagen’s 2017 Annual Report and financial statements, the company has set aside €3.4 billion in contingent liabilities related to the “Dieselgate” investor lawsuits.

   In August of this year, Volkswagen announced that it had preliminarily settled the U.S. ADR class action for USD $48 million. The ADR settlement amounts to approximately 1.4% of the €3.4 billion the company has reserved for contingent Liabilities related to the “Dieselgate” shareholder litigation. Therefore, the vast majority, or approximately 98.6% of the €3.4 billion contingent liabilities (€3.36 billion), remain for legal risks attributable to the diesel related investor lawsuits.

Coincidentally (or probably not), the correlation between USD $48 million that only addresses between 1% - 2% impacted U.S. ADR's float versus the XETRA float, puts the remaining contingent liability €3.36 billion squarely in the ballpark for addressing the remaining vast majority of the float and damages investors are seeking in Germany.

There are differences in claims under the law in the U.S. and Germany and while investors are claiming various damages of close to €10 billion in court in Germany, the contingent Liability Provision, illustrates that VW management is very informed and, potentially, is preparing itself for a settlement in this territory.

2. **Point 2.** VW needs to get the contingent liabilities and the material litigation exposure footnotes "off their financial statements". They need to do it for themselves and on behalf of the more than 500 institutional investors engaged in the "KapMuG" proceedings (of which many are still shareholders). As long as these legal matters remain on VW financial reports, the investment community will continue to discuss the contingent liability and handicap VW stock until a resolution is certain.

   To keep the VW litigation reporting and discussion alive at monthly, quarterly and annual management committee meetings and institutional investor executive meetings around the world, is simply not good business for VW who should focus on cleaning up its relationship with the capital markets.

   Point 3. VW has paid billions in fines to regulators for environmental violations and illegal practices related to "Dieselgate". Additional billions have been paid in remuneration to consumers to fix or replace vehicles. VW's multi-billion dollar apology tour around the world is commendable and appreciated by regulatory agencies and defrauded consumers.

   However, some of VW's greatest supporters are undoubtly its institutional investors who have arguably experienced the greatest financial brunt of the "Dieselgate" scandal through direct portfolio losses. For the VW organization, the VW brand name, and for investors around the world, a settlement can't come soon enough. We speculate VW will display the same German efficiency, as they have in dealing with regulators and consumers, by putting the investor issue behind them for good, sooner rather than later.

   Based on the above, we believe a settlement could, should, and probably will happen.

We say, get it done, sell some more cars and move on....!