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By Michael Goldhaber

Out of Gas

During its four-year pursuit of Volkswagen, little Porsche outmaneuvered the giant carmaker—but then sputtered at the finish. Were Porsche's lawyers to blame?

Photographs By Saverio Truglia

In late October 2008 James "J.B." Heaton III was teaching hedge fund litigation at Northwestern University School of Law when Porsche Automobil Holding SE shocked the financial world by announcing that it had secretly accumulated derivatives that, together with the shares it owned outright, gave it control over 74 percent of Volkswagen AG.

Hedge funds that had sold VW short and needed to cover their bets were caught in a classic squeeze, since there were not enough VW shares to go around. The stock price quintupled, VW briefly became the world's most valuable company, and the short traders lost billions. Initially seen as a masterstroke, Porsche's bold move would eventually backfire. Porsche and its lawyers understood the law but badly miscalculated the politics involved in making this deal. In the end, VW remained independent—and wound up owning Porsche.

Back in Chicago, Heaton told his students that a U.S. securities action against Porsche would be a no-brainer for any of the short funds that could establish U.S. jurisdiction. By day Heaton is a partner at Bartlit Beck Herman Palenchar & Scott LLP. So he and his German-speaking partner Kaspar Stoffelmayr were raring to go when two hedge fund clients, Elliott Associates, L.P., and Perry Partners L.P., asked the firm to consider such a suit. In January, Glenhill Capital LP, Glenview Partners LLC, and affiliates of Elliott and Perry sued Porsche for $1 billion in federal district court in Manhattan. Heaton says he will soon amend the complaint to include other funds with at least another half-billion dollars in losses.

This David-and-Goliath takeover saga (VW sells 60 times as many cars as Porsche) has been well told in the financial pages and our own ["Porsche Outdrives Volkswagen," *Focus Europe*, Winter 2009]. But from a lawyer's perspective, there remain two fascinating mysteries. First, where are the remaining billions of dollars in potential claims from other hedge funds? Second and more fundamentally, some quietly wonder whether Porsche's lawyers bear any blame for the failure of its grand plan. Who exactly counseled David to use a boomerang instead of a slingshot?

Heaton's hedge funds make the novel argument that Porsche's use of derivatives to hide its effective ownership position was a deceptive market practice that manipulated both the supply and demand of VW shares. The clincher, Heaton says, is that the market was indeed surprised when Porsche pulled back the curtain.

Plaintiffs also make the traditional argument that Porsche's statements affirmatively misled the market about its intent to take over VW. Most provocatively, the hedge funds allege that Porsche's head of investor relations flatly denied that the company was seeking a 75 percent stake in VW in phone calls with a Glenhill analyst and Glenview's CEO months or days before Porsche told the world that this was precisely its intent.

"The whole problem is that we didn't know David wanted to kill Goliath here," says Heaton. "David was saying, I'm happy with my 30–50 percent position in Goliath, and then suddenly says, I really want to kill Goliath, and by the way, I've already almost killed him." Porsche instructed its litigation counsel at Sullivan & Cromwell not to comment for this story and at press time had not yet filed a motion to dismiss.

Where are the rest of the hedge funds that were injured on the sidelines of the takeover contest? Apparently, they did not like their chances either in the United States or in Germany.

James "J.B." Heaton of Bartlit Beck argues that Porsche used derivatives to hide a de facto takeover of Volkswagen: "The whole problem is that we didn't know David wanted to kill Goliath here."

In the U.S., the main barrier is jurisdiction. The current plaintiffs are all either U.S. funds or international funds that include U.S. investors. Most are not obviously "F-cubed" plaintiffs—foreign investors who bought stock issued by a foreign company on a foreign exchange—but merely "F-squared." Thus, they have a better chance of proving that the defendant's conduct had effects in the U.S. It's a fair guess that the missing plaintiffs are predominantly European entities who expected the U.S. courts to slam their doors shut. The U.S. Court of Appeals for the Second Circuit adopted a relatively narrow rule on F-cubed jurisdiction in *Morrison* v. *National Australia Bank*, and most observers expect that rule to narrow further after the U.S. Supreme Court decides that case this term.

German courts are, of course, wide open to Europeans. But the German securities regulator, the Federal Financial Supervisory Authority (BaFin), has not objected to Porsche's maneuvering. Indeed, in August 2009 BaFin expressly found, in approving the takeover of the tire maker Continental AG using similar derivatives, that the type of "cash-settled swaps" used by Porsche do not give rise to disclosure duties, because they formally do not give the buyer physical possession of any shares. The opposite view has been taken by the U.S. courts, as well as the United Kingdom's Financial Services Authority, the Swiss legislature, and, as of February, the Committee of European Securities Regulators. All except Germany focus on the substance of hidden ownership and impose disclosure obligations based on synthetic derivatives. BaFin's opinion on hidden ownership is not binding on German courts, but it would be given significant weight in litigation. Moreover, German courts will only look to formal corporate statements as evidence of deception. To these hurdles, add the usual barriers to European litigation: the absence of contingency fees, the "loser pays" rule on attorney fees, and the resistance to large judgments. Not least, plaintiffs would face a cultural bias against those who engage in financial speculation.

Peter Dreier of Dreier Reidel in Düsseldorf, who specializes in shareholder representation, says that he in fact counseled hedge funds from all over the world against suing Porsche in German court last summer. "We said it's a high risk, and if you lose, you pay a lot. It's not worth it," he says. Dirk Zetzsche, a professor at the Center for Business and Corporate Law at Heinrich Heine Universität Düsseldorf, generally agrees with this assessment, although he is a leading critic of BaFin's opinion on hidden ownership. "If you ask me, the plaintiffs would have maybe a 25 percent chance against Porsche in German courts," he says. "And if you win, judges are very reluctant to write a check for a billion dollars. Judges might say, 'It was your bet, and your bet went wrong, and it's not the job of courts to give you money you couldn't get on the stock market.' This is the German cultural attitude."

Bartlit Beck's Kaspar Stoffelmayr, along with Heaton, represents funds that lost at least $1 billion when Porsche briefly controlled three-quarters of VW stock.

The plight of the hedge funds who shorted VW was only a fascinating sideshow to the historic death match between David and Goliath. Porsche's main legal adviser on its failed plan was Freshfields Bruckhaus Deringer, which declined to comment for this story. The reasons for Porsche's failure are quite clear. Foremost was the persistence of a German statute protecting VW, known as the "Volkswagen Law."

The 1959 VW law aimed to block takeovers of VW by requiring the assent of 80 percent of shareholders for key company decisions, like allowing an acquiror to "dominate" management. This effectively gave a blocking majority to VW's home state of Lower Saxony, which owns just over 20 percent of the carmaker's shares.

Starting in 2002, a line of cases in the European Court of Justice on such "golden shares" arrangements implied that the VW law violated European norms on the free movement of capital. The European Commission initiated proceedings against Germany in 2003.

Porsche and its counsel at Freshfields correctly bet that the European Court of Justice would find the VW law unlawful, which it did in October 2007, after Porsche's share purchases were well under way. But Porsche bet wrong that Germany would honor the ruling in good faith. Instead, the government of German chancellor Angela Merkel passed a new VW law that reinstated Lower Saxony's 20 percent blocking share, while omitting a less important provision that limited the voting rights of other shareholders. This gave a German district court in Lower Saxony the cover to uphold the new law, in November 2008.

An unamused European Commission has initiated proceedings against the new VW law. If Germany again loses and defies the decision, Brussels can impose daily fines—but what happens in Brussels has become ut-

DANGEROUS DRIVING

Porsche's sneak attack on Volkswagen shocked the markets, then backfired badly.

MARCH 2003
The European Commission initiates proceedings to overturn the Volkswagen Law, a statute that effectively allows shareholder Lower Saxony to block any major decision involving Volkswagen AG.

SEPTEMBER 2005
Porsche Automobil Holding SE says that it plans to buy 20 percent of Volkswagen.

MARCH 2007
Porsche acquires 30 percent of VW and under German law must bid for the entire company.

APRIL 2007
Porsche insists that it has no interest in acquiring VW, and its lowball bid for the company is rejected.

OCTOBER 2007
The European Court of Justice throws out the Volkswagen Law.

SEPTEMBER 2008
Porsche announces that it now owns 35 percent of VW. Meanwhile, Germany adopts a slightly revised version of the Volkswagen Law.

OCTOBER 2008
Porsche drops the bombshell: It now controls 74 percent of VW through a combination of shares and cash-settled swaps. Traders who had shorted VW rush to cover themselves, VW's share price soars, and hedge funds lose billions of dollars.

AUGUST 2009
To cover an estimated €15 billion in debt and losses stemming from the financial crisis, Porsche sells its car assets to VW and its VW swaps to Qatar. VW ends up in control of its would-be acquiror.

terly academic. The return of the VW law set in motion Porsche's demise.

"Porsche would absolutely have succeeded if the VW law fell, despite the financial crisis," says Wolf-Georg Ringe, a professor of corporate governance at Oxford University who has written on the VW golden shares litigation.

The financial crisis that began in fall 2008 did catch Porsche in a pincer movement. The plummeting of VW's stock price (along with all stock prices) led to margin calls on its swaps, perhaps in the range of €5 billion. Meanwhile, interest rates rose and credit terms tightened on more than €10 billion in short-term bank debt that Porsche had used to fund its attack.

But none of this would have mattered if the VW law had fallen. With a domination agreement in place, Porsche would have had access to VW's cash pile of more than €10 billion, and could have used VW's money to pay for its own acquisition.

Instead, in August 2009, Porsche was forced to surrender. With the legal help of Hengeler Mueller, Porsche plugged its €15 billion hole by selling its car division for €8 billion to VW (represented by Clifford Chance); and getting €7 billion from the Gulf state of Qatar (represented by Shearman & Sterling) for 10 percent of Porsche's holding company and 17 percent of VW (in the form of equity-settled swaps). The end result was that Volkswagen took over the Porsche carmaker and kept its own management, although the Porsche family held on to a majority of VW shares.

In hindsight, Porsche and Freshfields largely got the law and finance right, but misread the politics. Could they have foreseen that Merkel would reinstate the VW law? German observers speculate that Merkel sided with VW's Lower Saxony over Porsche's Bavaria for various reasons: because of personal and party ties to Lower Saxony's governor, because VW's workers had many more votes and its union more political power, or because Merkel is hostile to Porsche's slick and very un-German style in labor relations, executive compensation, and market speculation. In a contest between a carmaker and a carmaker playing hedge fund, Merkel chose the carmaker. To be sure, there were also strong reasons to expect Merkel to stay neutral, and many observers were surprised that she did not. But yes, in retrospect, the risk of the VW law remaining in force was foreseeable.

"The whole legal strategy was brilliant," comments one leading German corporate lawyer. "But you didn't have to be a mastermind to see that things could go wrong with the VW law. What I actually wondered was, 'Where's Plan B?' We never saw Plan B."

One possibility is that Porsche and its advisers did not anticipate the financial crisis. (Few did.) Without a credit crunch, Porsche might have patiently hung on for a few years with three-quarters of VW shares but without corporate control, until Europe forced Germany to back down on the VW law, or until VW's board or Lower Saxony surrendered.

The other possibility is that we did see Plan B. After all, who exactly came out a loser? Porsche's former CEO Wendelin Wiedeking received a $140 million golden parachute (now under challenge in German court), and earned $112 million in 2008 because he received nearly 1 percent of Porsche profits that were fattened by its temporary derivatives windfall. (Remarkably, Porsche's profits that year exceeded its revenues from automobile sales by €2 billion.) The Porsche family never won corporate control of VW because of the VW law, but it wound up with a majority stake in the world's largest carmaker.

> "Porsche would absolutely have succeeded if the VW law fell," says Oxford University's Ringe.

The silent advisers at Freshfields come off as financial geniuses with a tin ear for politics. Don't ask them to handicap the midterm elections in Stuttgart or Wolfsburg, but next time you want to make a run at a DAX 30 company, by all means give them a ring.

The only losers are the hedge funds who, after taking a beating in the short market on the sidelines, didn't like their chances under German securities law or U.S. jurisdictional rules. For those hedge funds with a good shot at winning jurisdiction, J.B. Heaton still hopes to have the last word.

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