



Bringing “big oil” to the Big Apple



Wolf Popper LLP partner **Emily Madoff** and **André de Almeida**, founding partner of Brazil's Almeida Advogados, recently filed the first class action in the US against Petrobras on behalf of purchasers of the American Depository Shares. Here they outline what the case involves and its implications for Latin American investors with interests in US markets.



For months, Brazil has been reeling from news of a scandal at Petrobras. In connection with federal investigations into a money-laundering scheme at the state-controlled oil company, it has been disclosed that construction companies that won contracts from Petrobras' refining division had diverted significant cash into slush funds for political parties. Police have identified 10 billion reais (US\$3.5 billion) of suspicious payments, making the Petrolão (the “big oil”) Brazil's biggest ever corruption scandal, likely to produce shameful headlines for many more months to come.

Petrobras' management is alleged to have facilitated a scheme in which third-party contractors paid bribes to certain influential individuals within Petrobras and other organisations in exchange for lucrative oil and gas construction contracts. Petrobras purportedly compensated the contractors for these bribes by paying inflated amounts under the contracts.

Besides Petrobras' executives, the reported bribery and kickback scheme also involved politicians and a large group of contractors, which formed a cartel to ensure its members would win Petrobras' major contracts. In November last year, *The Wall Street Journal* reported that Brazilian prosecutors and federal

police calculated that one Petrobras executive had granted contracts to Brazilian construction companies that “systemically inflated their costs by as much as 20 per cent”. After winning the contracts, the construction companies kicked back up to 3 per cent of a contract's total value in bribes to the Petrobras executive, Brazilian politicians and money launderers. Since the allegations surfaced, the price of Petrobras stock has dropped by more than half since September.

Compensation cultures

Brazil is not a suitable jurisdiction for investors wishing to be compensated for damages arising from the loss of value in their Petrobras investments. Compensation under these circumstances is uncommon in Brazilian case law and the securities regulations are much less sophisticated than US laws. Brazilian courts are not specialised in securities cases and a final decision could take many years to be issued, as all the while plaintiffs' legal fees continue to mount. These factors all create an incentive for the defendant to delay a settlement of the action. Beyond that, in the case of Petrobras, there is a risk of an adverse political impact to a plaintiff suing the state-controlled company for fraud.

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By contrast, the US has a unique legal structure allowing shareholders who purchased stock on a US stock exchange an opportunity to recoup their losses related to stock drops resulting from fraud. Under the Securities Exchange Act of 1934, and other US federal securities laws, fraud litigation can be commenced by foreign investors who purchased American Depository Shares (ADSs) of foreign corporations that trade on US exchanges, or who invested in shares of US domestic corporations.

An ADS is a US dollar-denominated form of equity ownership in a non-US company. It represents the foreign shares of the company held on deposit by a custodian bank in the company's home country, and carries the corporate and economic rights of the foreign shares. ADSs offer the same economic benefits enjoyed by the domestic shareholders of the non-US company. In some circumstances, where fraudulent conduct is committed within the United States but the corporation's shares trade elsewhere, investors in those shares can bring a fraud action in the US under foreign law, or US states' laws, but not US federal law. A securities litigation against Petrobras is currently under way in a federal court in New York City.

According to the Exchange Act, shareholders have the right to bring a private action in federal court to recover damages sustained as a result of securities fraud. Specifically, it prohibits the use of "any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the commission may prescribe." Implementing this section prohibits, among other things, making any "untrue statement of material fact ... in connection with the purchase and sale of any security".

The federal securities laws of the United States are enforced both by government agencies, namely the Securities and Exchange Commission and the Department of Justice, and by private parties. Private party litigation is principally responsible for providing investors with a mechanism to recoup their losses.

To prevail under the rule, private plaintiffs must prove that the defendant deliberately or recklessly made a material misrepresentation or omission connected with the purchase or sale of securities, and that the misrepresentation or omission caused the plaintiff to suffer economic loss.

In the *Petrobras* case, the complaint alleges that the company and its senior executives misrepresented and failed to disclose that the company was overpricing contracts to certain construction companies and accepting kickbacks from such companies approved for those contracts; that it was receiving multibillion-dollar bribes from third-party contractors to secure contracts from Petrobras; and that it was in violation of its own code of ethics as its employees

and executives were routinely accepting bribes from certain construction companies. It also alleges that Petrobras' own internal controls were ineffective and deficient, and that the company was aware of irregularities in connection with bribes from third-party contractors.

The class system

The pending *Petrobras* securities litigation was brought as a class action. Securities actions in the US are often brought as class actions because it would be too expensive for each individual shareholder to launch their own lawsuit. Class actions are attractive to aggrieved shareholders because attorneys customarily prosecute them on a contingent fee basis and advance all costs.

Class actions in the US are different from class or collective actions in other countries because in the US all members are included in the action unless they take steps to opt out. In most countries, class members must give notice that they wish to be included as a member of the class and may incur financial obligations in doing so. In the *Petrobras* case, the class action was brought on behalf of purchasers of Petrobras ADSs and other securities traded on US exchanges between 2 January 2010 and 26 November 2014.

Plaintiffs' damages in a securities fraud case are usually calculated as the difference between the price at which the stock sold and the price at which the stock would have sold without any artificial inflation caused by a defendant's misrepresentations or omissions. Plaintiffs in a securities fraud case must prove a causal connection and only that portion of the stock price drop attributable to the "revelation of the fraud" is recoverable as damages. In *Petrobras*, one issue is likely to be whether the declines in price were attributable to factors other than fraud, such as the decline in oil prices, the Brazilian presidential election or the wider Brazilian economy.

Typically, upon news of corporate fraud, several aggrieved investors file class action suits. The first plaintiff to file a securities class action is required to publish notice of the case, and other investors have 60 days to file motions with the court to be appointed lead plaintiff. At the end of the 60-day period, the judge determines the lead plaintiff and the lead plaintiff selects the counsel to prosecute the case. The lead plaintiff is defined by the Private Securities Litigation Reform Act (PSLRA) as the "most adequate plaintiff" – usually the investor who has the largest financial interest in the relief sought by the class.

Due to the PSLRA's directive regarding the most adequate plaintiff, large institutional investors usually

control securities class actions. In the *Petrobras* case, foreign investment management companies and US state pension funds filed lead plaintiff motions, along with some small investment companies and individual investors. Their losses range from US\$268 million to US\$5,000.

Investors may seek appointment as lead plaintiff for a variety of reasons. The lead plaintiff selects legal counsel for the class and negotiates a fee agreement, which is subject to approval by the court. Furthermore, the lead plaintiff is involved in all significant strategic decisions, including the length of the class period, the persons and entities to be named as defendants, and appropriate amounts for settlement, which enables the lead plaintiff to maximise any recovery. In passing the PSLRA, the US Congress considered that having investors with the largest losses serve as lead plaintiff would facilitate better enforcement of the securities laws, and expressed hope that the provisions would encourage large investors to volunteer to serve as lead plaintiffs. However one consequence of the responsibilities placed on lead plaintiffs, and the requirement that the lead plaintiff not receive more from the litigation than the other class members, is investors with very significant losses sometimes elect to opt out of the class action and pursue an action on their own.

A global enterprise

Many large, publicly traded international companies trade ADSs in the US. Petrobras alone has 3.7 billion ADSs listed on the New York Stock Exchange, with an average daily trading volume of 33.5 million shares. By comparison, the state-controlled company lists 7.4 billion shares on Brazil's BM&F Bovespa, with an average daily trading volume of 18 million shares. The price action between the two securities track each other.

Clearly, investing has become a global enterprise. From Brazil, examples of other ADSs traded on US exchanges include mining company Vale, banks Itaú Unibanco and Banco Bradesco, brewer AmBev and aerospace company Embraer. Elsewhere in Latin America, Banco Santander from Chile and Mexico's Cemex are also listed, while further afield UK oil company BP and Chinese web services provider Baidu are examples of those also listed.

Sophisticated investors from around the world take large positions in US companies traded on the US exchanges, and also purchase ADSs of foreign corporations traded on US exchanges. Attorneys for those investors are well advised to be knowledgeable about the US securities laws, as the US provides their clients with a reliable forum to recoup trading losses suffered as a result of corporate fraud.