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Flawed Petrobras Settlement Bypasses Many Shareholders

By **David Andrew Taylor** (January 24, 2020, 4:23 PM EST)


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According to Pomerantz LLP, class counsel in the In re Petrobras Securities Litigation in the U.S. District Court for the Southern District of New York, the $2.95 billion settlement reached in the litigation marked a "significant victory for investors" of the semi-public Brazilian corporation Petróleo Brasileiro SA, or Petrobras.

The class action was brought on behalf of investors holding common and preferred Petrobras American depositary shares traded on the New York Stock Exchange, and/or certain Petrobras debt securities, the price of which fell drastically when a Brazilian federal police investigation known as Operation Car Wash exposed a multibillion-dollar money-laundering and corruption scheme within Petrobras, which, via false and misleading public statements, the company did not fully disclose to investors.

Analysis of the data shows that large numbers of street-name holders of Petrobras securities covered by the terms of the class action were not notified of the settlement, and never received a proof of claim and release form to fill out to stake their claim.

Furthermore, the settlement stipulates a cy pres relief contribution of nondistributed or unclaimed net settlement funds "to an appropriate non-profit organization selected by Class Counsel, with approval by the Court, in which Class Counsel shall not have any financial interest or other affiliation" — a contribution which provides no benefit to class members whatsoever.

For a just settlement, the claims distribution notice and processing in the securities class action should work properly for investor class members, and the class action settlement award should work for them fully and directly.

As stated in court documents, before and during the time period from Jan. 22, 2010, to March 19, 2015, Petrobras expanded its petroleum production capacity through construction and oil refinery purchases. The expansion was coordinated between corrupt Petrobras executives and a cartel of project contractors and suppliers at grossly inflated bidding prices, established to pay bribes and kickbacks to the executives and to government officials.

This corruption scheme was known by upper management, including the head of Petrobras' energy and gas division and the CEO and president of the company. The scheme was discovered by the Brazilian federal police investigation, and, as its details gradually unfolded, the value of Petrobras' securities declined. The price of its common American depositary shares fell by 80.92%, and the price of its preferred American depositary shares by 78.01%, over the course of the aforementioned period.

On Dec. 8, 2014, the first putative securities class action against Petrobras — Kaltman v. Petrobras — was filed in the U.S. District Court for the Southern District Court of New York. Four other putative securities class actions were subsequently filed, asserting similar claims, and consolidated together with the Kaltman action by court order.

On Feb. 2, 2016, the court certified an Exchange Act class and a Securities Act class, for class action pursuit of claims under the U.S. Securities Exchange Act of 1934 and Rule 10b-5 anti-fraud provisions, and the U.S. Securities Act of 1933. Inter alia, mediation sessions were held between class counsel and the Petrobras defendants towards achieving settlement. Final judgment was

entered on July 2, 2018.

To have filed a claim and recover from the net settlement fund, settlement class members must have duly submitted a proof of claim form, mailing it to the court-appointed settlement, claims and notice administrator by June 9, 2018, or submitting it to a website online. The court determined that notice be mailed to settlement class members identified through reasonable efforts (Federal Rule of Civil Procedure 23 (c)(2) states that "individual notice should be given to all members who can be identified through reasonable effort").

In the claims and notice administrator's declaration to the court, 645,693 class members were identified from its notice of pendency mailing. An additional 2401 class members were identified by Petrobras' counsel, for a combined total of 648,094. A further 367,647 notice packets were mailed to brokers, nominees and others identified through a proprietary GCG database of U.S. brokers and overseas affiliates.

It was stated in the declaration that this third source — "as in most cases of this nature" — would represent the large majority of potential class members. However, from the data presented in the declaration, it is evident that this is clearly not the case. The number of class members identified (367,647) is only 57% of the number (648,094) obtained from just the original notice of pendency mailing and the Petrobras contact information.

The presented data relate to the notification response from brokers worldwide, and therefore strongly suggest that something is seriously wrong here. There are many missing investors. The problem may relate to the methodology used in the notification process, and the need for internal checks to verify this process.

In the case of Brazilian investors, the discrepancy might be much larger, since Petrobras is a major Brazilian company with a lot of prestige, and is very popular with Brazilian investors. There are undoubtedly large numbers of Brazilian street-name holders of Petrobras American depositary receipts (acquired through U.S. depository banks and U.S. registered brokers) that have not been notified of the settlement, and have never received a proof of claim form.

The brokers, of course, would be the brokers of the Brazil offices of the U.S. brokerage firms, and this has direct relevance in terms of possible effects of local conditions — class actions in Brazil are very rare and not well understood — on the basic result that many settlement class members did not receive actual notice, including those with large financial interests.

"Cy pres" comes from "cy pres comme possible," a French expression signifying "as close or near as possible." Judicial cy pres was developed in England as a way of honoring a testator's intent as closely as possible. The earliest judicial use of cy pres relief in the U.S. class action context was in the 1974 Miller v. Steinbach decision in the Southern District of New York.

In that case, a proposed class settlement to a shareholder suit concerning alleged unfair merger terms and violation of securities laws was determined to be "fair and reasonable" in applying the cy pres doctrine to pay the settlement fund to the trustee of the shareholding company's retirement plan, in "view of the very modest size of the settlement fund and the vast number of shares among which it would have to be divided."

Cy pres settlements have come under increasing scrutiny over the years. But on March 20, 2019, in a per curiam decision, the U.S. Supreme Court declined to rule on the merits in Frank v. Gaos, a case concerning cy pres settlement in a class action, for reason of the threshold question of standing.

And on June 24, 2019, the high court denied a petition for certiorari in Perryman v. Romero, which also concerned cy pres settlement in class action, because of the automatic stay that went into effect upon the bankruptcy filing of a respondent. So in the two main recent cases before the court on the question of cy pres in class action, no decision was rendered.

The Frank v. Gaos case, although not resolved by the Supreme Court, has nevertheless resulted in substantive legal opinion on the matter. In its Frank v. Gaos brief for the United States as amicus curiae supporting neither party, the Solicitor General of the United States enumerated three important principles relevant to the question presented in the case regarding the inappropriateness of cy pres award in class actions.

The brief stated that: (1) cy pres distributions are permissible only if they redress plaintiffs'

injuries, and only if there is no nonarbitrary way to distribute settlement funds to allegedly injured class members; 2) "by allowing the parties or the court to select the recipients of charitable contributions, cy pres relief opens the door to apparent favoritism toward entities with which the parties or the court have prior affiliations, such as an alma mater or favorite local charity"; and 3) "it is inherently dubious to apply a doctrine associated with the voluntary distribution of a gift to the entirely unrelated context of a class action settlement."

The brief further noted that, although "cy pres remedies 'are a growing feature of class-action settlements' … such settlements are irreconcilable with the logic of cy pres as historically understood ... because the need for cy pres arose only when a donor's intent was frustrated, there was no such thing as a voluntary cy pres agreement or award."

On Sept. 26, 2018, the U.S. Department of Justice entered into a three-year nonprosecution agreement with Petrobras, bringing to a close the DOJ's and U.S. Securities and Exchange Commission's investigations into the company that had preceded the filing of the Petrobras securities litigation. According to the nonprosecution agreement, out of a total criminal penalty of $853.2 million, Petrobras would pay $85.32 million each to the DOJ and the SEC, and would pay the remaining $682.56 million (80% of the total) to Brazilian authorities. On the following day, the SEC settled its enforcement action against Petrobras.

On Jan. 23, 2019, the Car Wash task force of Brazil's Federal Prosecution Service entered into an agreement with Petrobras that allocated half of the funds to social and educational programs to promote citizenship and integrity in Brazil's public sector. The other half of the funds was to be used to compensate Petrobras investors on the Brazilian stock exchange B3 who had legal suits or arbitration against Petrobras in progress prior to Oct. 8, 2017. The agreement was ratified by the Federal Court of the State of Parana.

However, on Sept. 17, 2019, Brazilian Supreme Court Justice Minister Alexandre de Moraes ratified an agreement between the office of the prosecutor general of Brazil, the president of the Brazilian House of Representatives and the attorney general of Brazil. Under this agreement, the amounts deposited by Petrobras are now destined for "infant education" and "the combat of forest fires."

Conclusion

There are a number of disturbing elements in the In re Petrobras Securities Litigation settlement. There appears to have been a serious failure in the notification process — as a result of which many thousands of valid shareholder claimants, in Brazil and in other areas outside the U.S., were not even notified of the proceedings and were not included in the class action, and therefore were denied legal redress.

Additionally, the $682.56 million cy pres award in the Petrobras settlement with the DOJ and SEC represents a farcical failure to apply the basics of the cy pres doctrine. The intent of cy pres has been subverted to finance Brazilian infant education and combat forest fires. The Petrobras class action cy pres award portends no better. So while the Petrobras settlement may be a significant victory, there are aspects of the settlement that do not warrant unreserved, enthusiastic celebration.

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Disclosure: The author's firm filed the first putative securities class action against Petrobras in 2014 (Kaltman v. Petroleo Brasileiro SA).

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