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Auction Rate Securities Litigation: From Multi-Billion Dollar Regulatory Settlements to Dismissals of Private Actions

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The market for auction rate securities (ARS), a $330 billion market that operated successfully for over 20 years, experienced significant failures in August 2007 and widespread failures in February 2008. These failures led to over $50 *billion* in regulatory settlements by underwriters and by downstream firms that purchased and resold ARS but did not underwrite them. The regulatory actions have been followed by a deluge of lawsuits and arbitrations. This article assesses the scope and current outcomes of those private actions.

Background

The ARS market began in the mid-1980s and ran successfully with only isolated failures for about 20 years, until the financial crisis beginning in August 2007. ARS are typically long-term variable rate instruments with interest rates that are periodically reset through auctions generally taking place every 7, 14, 28, or 35 days. ARS trade through what is called a Dutch auction, in which bids with successively higher rates are accepted until all securities in the auction are sold. The final rate at which securities are sold is the "clearing rate," which is the lowest bid sufficient to cover all securities for sale in the auction, and applies to all securities until the next auction. An auction fails when there are not enough bids to cover the securities for sale, such that generally the current holders continue to hold the securities, and the issuer then must pay a "fail rate," usually an above-market rate set by a formula described in the disclosure documents for each ARS.

Initially, most ARS were preferred securities issued by closed-end mutual funds or securities backed by municipal bonds or student loans. Later, ARS also were issued by a variety of other issuers including corporations and special purpose vehicles and were backed by a variety of instruments including collateralized debt obligations (CDOs) and mortgage-backed securities. Purchasers of ARS have included both institutions, which used the ARS as cash management vehicles, and retail investors, who used ARS as alternatives to money market funds.

Regulatory Settlement of 2006

In 2004, the Securities and Exchange Commission (SEC) began investigating the underwriting practices and auction processes for ARS. This investigation resulted in settlements totaling $13.375 million in May 2006 with 15 banks and brokerage firms.[1] The SEC settled with three additional firms in January 2007 for a total of $1.6 million.[2] In these settlements, the SEC alleged that several practices violated Section 17(a)(2) of the Securities Act of 1933, including, among other things:

- Bidding to prevent auction failures without adequate disclosure;

- Bidding to set a clearing rate without adequate disclosure; and
- Bidding to prevent an "all hold" auction (where investors decide to hold at any rate and holders earn the all-hold rate set forth in the offering documents until the next auction) without adequate disclosure.

One requirement of the settlements was that each firm had to distribute to its clients and post on its publicly available website a description of the firm's ARS practices and procedures. These public descriptions typically disclosed, among other things, that underwriters could and did routinely place bids to prevent auction failures and to set clearing rates. These, and other disclosures in offering materials, have had a significant impact on subsequent private litigation.

Events of 2007 and 2008

As the broader credit crisis struck in August 2007, the ARS market experienced auction failures, particularly affecting those ARS where there were concerns about issuers' credit, including concerns about securities connected to the subprime market. The markets worsened over the next several months and, by February 2008, concerns about the credit crisis, liquidity, and monoline insurers resulted in failures of all types of ARS. While most of the issuers continued to pay interest at the "fail rate," these failures left investors with largely illiquid securities.

After the auction failures of August 2007 and February 2008, there was an outcry by investors and the media concerning investors' inability to sell what they had considered safe, liquid investments. Several state regulatory authorities[3] and the SEC commenced investigations, resulting in settlements whereby a number of underwriting firms agreed to purchase over $50 billion of ARS from their own retail customers.[4] With certain exceptions, the settling firms did not agree to purchase ARS from their institutional clients or to purchase structured ARS (e.g., CDO ARS). Subsequently, a number of downstream firms entered into settlements with the Financial Industry Regulatory Authority (FINRA) resulting in additional purchases from clients.[5] Since the settlements did not cover all purchasers of ARS, many investors left out of the settlements began to sue.[6]

Litigation

Investors not included in the settlements have brought over 50 ARS lawsuits within the past few years.[7] In addition, investors have brought over 650 arbitrations before FINRA. Although plaintiffs have achieved mixed results in arbitration,[8] not a single ARS lawsuit has yet survived the motion to dismiss phase and many have been dismissed.[9]

With all the regulatory charges, settlements, and billions of dollars of purchases by firms without litigation, why are these ARS claims in private litigation now being dismissed? While there are several reasons, there are two principal explanations: (1) courts have taken a close look at the "manipulation"[10] and "disclosure" allegations and have not been satisfied that, in light of the disclosures that *were* made, the allegations have been sufficient[11]; and (2) plaintiffs have been unable to sufficiently allege those elements of a private cause of action not required in regulatory proceedings, such as reliance[12] and loss causation.[13]

There generally have been three types of plaintiffs involved in these actions, most of whom were excluded from the regulatory settlements: (1) retail investors who were not compensated as a result of any of the regulatory settlements (sometimes brought as class actions); (2) institutional investors; and (3) issuers of securities claiming to have been damaged by having to pay the higher "fail rate" because of auction failures.[14] The three principal types of defendants have been: (1) underwriting firms that managed and underwrote the auctions; (2) downstream firms that did not underwrite ARS, but that purchased and resold ARS to their customers; and (3) rating agencies.[15]

Plaintiffs' claims typically involved either customers of a firm alleging a failure to disclose or a misrepresentation about the safety and liquidity of ARS, or downstream purchasers alleging that the underwriter, with which the purchaser had no direct relationship, manipulated the market. Other claims include those against issuers alleging misrepresentations or omissions about the demand for or liquidity of ARS,[16] and those against rating agencies alleging negligent misrepresentations about ARS liquidity. Plaintiffs allege violations of the federal securities laws, but also claims under various state statutory and common law theories. Unlike the SEC, which brought misrepresentation and omission claims under Section 15(c) of the Securities Exchange Act of 1934 (Exchange Act) under which there is no private right of action,[17] private litigants brought misrepresentation and omission, as well as manipulation, claims under Section 10(b) of the Exchange Act.

In one of the most recent ARS decisions, *In re UBS Auction Rate Securities Litigation*, the Court dismissed the complaint on the ground that a claim of manipulation cannot be based on conduct and risks that were disclosed to the investing public.[18] The Court found that information in the ARS prospectuses disclosed the "very conduct of which Plaintiffs primarily complain—the placing of support bids—and the information advantages that Defendants would have if they did engage in such conduct."[19] "Since, regarding this practice, Plaintiffs were not led to believe one thing when another was true, a reasonable jury could not find that Defendants' alleged conduct was deceptive."[20] The Court recognized that the gravamen of manipulation is deceiving investors into believing that prices at which they purchase and sell securities are determined by the natural interplay of supply and demand and, therefore, non-disclosure is essential to a manipulation claim.[21] The Court also found that, in the 2006 settlement, the SEC opined that underwriters could properly place bids for their own accounts in auctions, provided that the practice was properly disclosed.[22] Another Court considering a manipulation claim found that the various disclosures made by defendants "negate the Plaintiffs' claims that [defendant] misled the market into believing that the price of the securities and the clearing rates set by the auctions were dictated by the natural interplay of supply and demand."[23]

Courts have dismissed ARS cases for failure to prove misrepresentations or omissions. In *Ashland Inc. v. Oppenheimer & Co.*,[24] Ashland alleged that Oppenheimer made material misrepresentations and omissions regarding the health of the ARS market, which induced Ashland to participate based on false pretenses. Ashland also alleged that Oppenheimer made material omissions and misrepresentations regarding the safety, liquidity, and quality of ARS. For example, Ashland alleged that Oppenheimer's ARS disclosure document did not disclose the maximum fail rate in the case of a failed auction.[25] The Court found that the document did state that a method for calculating the maximum rate was specified in the offering documents for each ARS, that the rates varied, and that Oppenheimer could not ensure that a particular auction would clear at a favorable rate for the investor.[26] The Court also found that Ashland failed to allege with sufficient particularity that Oppenheimer's statements were false or misleading when made.[27]

In *In re Merrill Lynch Auction Rate Securities Litigation*,[28] the Court found that plaintiffs could not satisfy the reliance element of securities fraud. Plaintiffs could not utilize the fraud on the market presumption because "the ARS market would have incorporated the 2006 SEC Order, Merrill Lynch's website disclosure, and the prospectuses for the ARS at issue."[29] In addition, the Court concluded that plaintiffs failed to allege justifiable reliance.[30] In particular, the Court held that, because defendant had disclosed its practice of intervening in auctions, plaintiffs could not have justifiably relied on an assumption that defendant had *not* been intervening in auctions.[31]

Courts also have dismissed ARS claims for failure to allege scienter. In *Ashland Inc. v. Morgan Stanley & Co.*, the Court found that "[i]n the absence of more specific allegations of 'reports or statements' that

demonstrate Morgan Stanley's knowledge of facts contradicting statements made by Morgan Stanley to Ashland, the [amended complaint] fails to meet the standard for pleading scienter."[32] The Court also concluded that plaintiffs' theory regarding Morgan Stanley's motivation was economically irrational—if Morgan Stanley purchased ARS it believed to be illiquid simply to induce Ashland's purchases, then Morgan Stanley itself would have been left in an illiquid position also.[33] In analyzing scienter, courts distinguish between culpability and mere bad business judgment. The Southern District of New York in *In re Citigroup Auction Rate Securities Litigation* dismissed a market manipulation claim where plaintiff's allegations suggested that defendant's purchases of ARS were as likely to have been motivated by bad business judgment as by an intent to deceive the market.[34] The Court also held that legitimate business motivations for purchasing ARS, such as offsetting subprime market losses or obtaining fees for services in connection with the auctions were insufficient to meet the scienter requirement.[35]

The failure to plead loss causation and damages have also led to dismissals. In *Healthcare Financial Group, Inc. v. Bank Leumi USA*,[36] the Court dismissed the claims because plaintiff failed to establish that the alleged material misrepresentations caused its loss.[37] Likewise, in *In re Citigroup Auction Rate Securities Litigation*,[38] the Court found that plaintiff "failed to allege that he suffered any specific economic harm as a result of Defendants' conduct and, thus, he has not alleged loss causation sufficiently."

Conclusion

Although it may seem strange for so many private ARS cases to be dismissed at the pleading stage after the regulatory agencies exacted settlements and billions of dollars of purchases by firms, these results are not so surprising. As one court observed, the settling firms neither admitted nor denied liability as part of the settlements, the settlement orders have limited authority because they were not reviewed by any Article III court, and the settlement orders were reached in the context of Section 15(c) of the Exchange Act, which is not at issue in the current litigations.[39] Moreover, the extensive disclosures in the offering documents, news media, the 2006 SEC settlement, and firms' public websites regarding defendants' auction practices have so far made it impossible for plaintiffs to sufficiently allege manipulative activity, deception, justifiable reliance, scienter, loss causation, and damages. Since some of the decisions are on appeal and other actions and arbitrations remain pending, we have not yet heard the last word on ARS litigations.

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1 SEC Release Nos. 33-8684 and 34-53888 (May 31, 2006).

2 SEC Release No. 33-8767 (Jan. 9, 2007).

3 Certain states took responsibility for leading the investigations. Among the most active state regulators were the New York Attorney General's Office and the Massachusetts Division of Securities.

4 Firms that settled with regulators in 2008 and 2009 included Bank of America, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, J.P. Morgan, Merrill Lynch, Morgan Stanley, RBC Capital Markets, TD Ameritrade, UBS, and Wachovia.

5 Firms that settled with FINRA in 2008 and 2009 included BNY Mellon Capital Markets, City National Securities, City Securities Corporation, Comerica Securities, Fifth Third Securities, First Southwest, Harris Investor Services, Janney Montgomery Scott, M&I Financial Advisors, M&T Securities, NatCity Investments, Northwestern Mutual Investment Services, and WaMu Investments.

[6] Certain ARS plaintiffs unsuccessfully tried to centralize ARS-related suits against 29 different broker-dealers. *See In re Auction Rate Sec. (ARS) Mktg. Litig.*, 581 F. Supp. 2d 1371, 1372–73 (J.P.M.L. 2008).

[7] Cases brought by or on behalf of investors whose ARS were purchased as a result of the regulatory settlements have been dismissed for lack of standing or because of an inability to allege any damage. *See, e.g.*, *In re UBS Auction Rate Sec. Litig.*, No. 08-CV-02967, 2009 BL 69423 (S.D.N.Y. Mar. 30, 2009); *Aimis Art Corp. v. Northern Trust Sec., Inc.*, 641 F. Supp. 2d 314 (S.D.N.Y. 2009).

[8] Some investors have prevailed in arbitrations, as in *STMicroelectronics v. Credit Suisse Securities LLC*, FINRA Case No. 08-00512 (Feb. 12, 2009), where the claimant was awarded $400 million in compensatory damages based on claims of securities law violations. In *Kajeet, Inc. v. UBS Financial Services, Inc.*, FINRA Case No. 09-03390 (Aug. 3, 2010), a claimant was awarded $80.8 million including consequential damages. In *Westervelt Co. v. Banc of America Sec. LLC*, FINRA Case No. 08-04948 (Mar. 30, 2010), a customer-investor was awarded $5.5 million in compensatory damages on its causes of action for rescission, unsuitability/fair dealing, fraud/manipulative practices, breach of fiduciary duty, breach of contract, failure to supervise/negligent supervision, and negligence/negligent misrepresentation. Another arbitration panel required Citigroup to purchase all student loan ARS purchased by Intevac through Citigroup. *Intevac, Inc. v. Citigroup Global Mkts., Inc.*, FINRA Case No. 09-01477 (June 29, 2010). In another arbitration, Credit Suisse was ordered to purchase $7.1 million of ARS from an investor. *Luby's Restaurants LP v. Credit Suisse Sec. (USA), LLC*, FINRA Case No. 08-04007 (May 21, 2010). Recently, an arbitration panel ordered Raymond James to purchase $2.45 million of ARS from an investor. *Merdinger v. Raymond James Fin., Inc.*, FINRA Case No. 09-03475 (July 19, 2010).

[9] *See, e.g.*, *Tamar v. Mind C.T.I., Ltd.*, No. 09-CV-07132 (S.D.N.Y. July 2, 2010); *In re UBS Auction Rate Sec. Litig.*, No. 08-CV-02967 (S.D.N.Y. June 10, 2010); *Rich v. Wachovia Bank*, No. 08-CV-81575 (S.D. Fla. Apr. 7, 2010); *In re Merrill Lynch Auction Rate Sec. Litig.*, No. 08-CV-03037, 2010 BL 71278 (S.D.N.Y. Mar. 31, 2010); *Ashland Inc. v. Morgan Stanley & Co.*, No. 09-CV-05415, 2010 BL 70181 (S.D.N.Y. Mar. 30, 2010); *Teva Pharm. Indus. v. Deutsche Bank*, No. 09-CV-06205 (S.D.N.Y. Mar. 24, 2010); *Pivot Point Capital Master LP v. Deutsche Bank*, No. 08-CV-02788 (S.D.N.Y. Mar. 24, 2010); *Oughtred v. E*Trade Fin. Corp.*, No. 08-CV-03295 (S.D.N.Y. Mar. 18, 2010); *Ashland Inc. v. Oppenheimer & Co.*, 689 F. Supp. 2d 874 (E.D. Ky. 2010); *Healthcare Fin. Group, Inc. v. Bank Leumi USA*, 669 F. Supp. 2d 344 (S.D.N.Y. 2009); *Zisholtz v. Suntrust Banks, Inc.*, No. 08-CV-01287 (N.D. Ga. Sept. 24, 2009); *Defer LP v. Raymond James Fin., Inc.*, 654 F. Supp. 2d 204 (S.D.N.Y. 2009); *In re Citigroup Auction Rate Sec. Litig.*, No. 08-CV-03095, 2009 BL 194417 (S.D.N.Y. Sept. 11, 2009); *Aimis Art Corp. v. Northern Trust Sec., Inc.*, 641 F. Supp. 2d 314 (S.D.N.Y. 2009); *Openwave Sys. Inc. v. Fuld*, No. 08-CV-05683 (N.D. Cal. June 6, 2009).

[10] *See, e.g.*, *In re UBS Auction Rate Sec. Litig.*; *In re Merrill Lynch Auction Rate Sec. Litig.*, 2010 BL 71278 (currently on appeal to Second Circuit).

[11] *See Ashland Inc. v. Oppenheimer & Co.*, 689 F. Supp 2d at 882–85. Courts also have dismissed private actions because of a failure to allege scienter, particularly in light of the firms' disclosures. *See Ashland Inc. v. Morgan Stanley & Co.*, 2010 BL 70181, at *21–24; *In re Citigroup Auction Rate Sec. Litig.*, 2009 BL 194417, at *11–13.

[12] *See, e.g.*, *In re Merrill Lynch Auction Rate Sec. Litig.*, 2010 BL 71278, at *30–54; *Ashland Inc. v. Morgan Stanley & Co.*, 2010 BL 70181, at *24–27.

[13] *See, e.g.*, *Healthcare Fin. Group, Inc. v. Bank Leumi USA*, 669 F. Supp. 2d at 349–50; *In re Citigroup Auction Rate Sec. Litig.*, 2009 BL 194417, at *16. Courts also have dismissed ARS cases because of a failure to meet heightened pleading standards in fraud cases. *See, e.g.*, *Zisholtz v. Suntrust Banks, Inc.*; *Defer LP v. Raymond James Fin., Inc.*, 654 F. Supp. 2d 204.

[14] Motions to dismiss the issuer claims have been made. The motions are pending and no decisions with respect to the issuers' claims have been rendered yet. In addition, investors in funds that purchased ARS have filed actions alleging that the fund managers improperly used the funds'

assets to purchase ARS at a premium to their market value, contrary to investors' interests. *See Rotz v. Van Kampen Asset Mgmt.*, No. 651060/2010 (N.Y. Sup. Ct. July 22, 2010); *Curbow Family LLC v. Morgan Stanley Inv. Advisors Inc.*, No. 651059/2010 (N.Y. Sup. Ct. July 22, 2010).

[15] Motions to dismiss have been made by the rating agencies, but these motions have not yet been decided.

[16] There have been isolated cases where ARS issuers have been named as defendants and there have been dismissals in those cases as well. *See, e.g.*, *Miller v. Calamos Global Dynamic Income Fund*, No. 08-CV-03756 (S.D.N.Y. Sept. 22, 2008).

[17] *See Kidder Peabody & Co. v. Unigestion Int'l, Ltd.*, 903 F. Supp. 479, 493–95 (S.D.N.Y 1995).

[18] No. 08-CV-02967, at 46 (S.D.N.Y. June 10, 2010).

[19] *Id.* at 46–47.

[20] *Id.* at 47.

[21] *Id.* at 45.

[22] *Id.* at 48.

[23] *In re Merrill Lynch Auction Rate Sec. Litig.*, 2010 BL 71278, at *27; *see also Teva Pharm. Indus. v. Deutsche Bank*.

[24] 689 F. Supp. 2d at 882.

[25] *Id.* at 883–84.

[26] *Id.* at 884.

[27] *Id.*

[28] 2010 BL 71278, at *31–54.

[29] *Id.* at *36.

[30] *Id.* at *49–54.

[31] *Id. See also In re Citigroup Auction Rate Sec. Litig.*, 2009 BL 194417; *In re UBS Auction Rate Sec. Litig.*

[32] 2010 BL 70181, at *24.

[33] *Id.* at *22–23.

[34] 2009 BL 194417, at *13.

[35] *Id.* at *12; *see also Defer LP v. Raymond James Fin., Inc.*, 654 F. Supp. 2d 204.

[36] 669 F. Supp. 2d 344.

[37] *Id.* at 349–50.

[38] 2009 BL 194417, at *16.

[39] *In re UBS Auction Rate Sec. Litig.*, No. 08-CV-02967, at 48 n.11.