

## Recent Developments in Auction Rate Securities Litigation

In 2007, cracks appeared in the \$330 billion market for Auction Rate Securities (ARS) when several ARS auctions failed for closed end funds offering preferred stock backed by subprime debt. Then, in February 2008, the ARS auction market collapsed. More than 80% of the scheduled auctions failed on February 13 and 14, and most of the auctions since then have also failed. So far, only a limited secondary market for ARS has developed.

Auction Rate Securities (ARS) were invented in the mid-80s as very short-term investments offering relatively high yields. ARS, in the form of bonds and preferred stock, are sold in large denominations (e.g., \$25,000 or more per unit). The securities always sell at par but their interest rates reset at regular and frequent auctions, usually every 7, 28 or 35 days. Because the auctions occur frequently, ARS holders theoretically enjoy substantial liquidity.

In an ARS auction, sellers and bidders for a given ARS communicate their wishes beforehand to an "Auction Agent" acting for the issuer. The sellers announce their intention to sell while the bidders declare both their willingness to buy and the interest rates they are willing to accept. The Auction Agent then examines and ranks all of the bids and determines the "clearing rate," *i.e.*, the lowest interest rate at which all of the available securities will sell. The bidders willing to accept interest rates at or below this clearing rate receive the securities, and all of the holders receive the new interest rate from the issuer until the next auction takes place.

If there are not enough bids to "clear" all of the ARS available for sale, the result is a "failed auction" and no ARS change hands. Beyond that, the financial consequences vary from security to security. In general, the issuer provides a predetermined "failure rate" to all of the holders. In practice, "failure rates" vary considerably, with some ARS offering "failed auction" interest rates substantially higher than the pre-failure market and others only slightly higher.

The harm from the recent failed auctions has not fallen evenly. Some (but not all) issuers have been forced to make substantially higher interest payments and have scrambled to find new financing to redeem their suddenly-expensive ARS. Some (but not all) holders unable to liquidate their ARS have been forced to reclassify their debt as long-term investments or report write-offs because of the modest interest they are receiving and/or the increased risk that they will never be able to resell the bonds at par.

Some large financial institutions have participated in the ARS market in different and potentially conflicting roles, for example by acting as auction agents for the issuers, advising clients about ARS investments, and bidding on ARS for the institution's proprietary account. Historically, the institutions providing auction services have also intervened to prevent auction failures by buying securities that otherwise would not have sold. In the recent auction failures, these institutions declined to intervene. At the conclusion of an SEC investigation in 2006, 15 major broker dealers (larger investment banks) paid fines and agreed to be more explicit about their institution's various roles, to conform to their disclosed auction procedures, and to refrain from certain practices.

In the wake of recent auction failures, the Securities and Exchange Commission (SEC), the Financial Industry Regulatory Authority (FINRA), and the Massachusetts Secretary of State are again probing how ARS have been marketed.<sup>1</sup> In March, the SEC announced that it would not pursue enforcement actions against “Municipal Issuers, Conduit Borrowers ... dealers and auction agents” who take part in markets for auction rate securities so long as they make appropriate disclosures.<sup>2</sup> On April 14, however, the New York’s Attorney General, Andrew Cuomo, launched yet another “industry investigation” with subpoenas to 18 major financial institutions seeking information about ARS marketing.

Another wave of litigation is beginning to appear – customer litigation. Much of this will be in the form of NASD arbitrations against brokers and brokerage houses. However, suits also may involve commercial banks or other entities who originated loans secured by now illiquid securities, or securities that now have depreciated in value as a product of their credit risk and interest rates.

Many of the ARS auction failures are unrelated to subprime investments or are related only in the sense that declining liquidity and investor fears have affected many markets. The lawsuits below, however, combine claims relating to ARS with allegations regarding subprime debt.

#### **Filed February 1, 2008:**

*In the Matter of Merrill Lynch, et al.*, Docket No. 2008-0001 (Boston, Mass.): Merrill Lynch recently paid \$13.9 million to settle claims brought by the city of Springfield, Mass., that it inappropriately invested the city’s money in ARS.<sup>3</sup> In an Administrative Complaint, the city alleged that Merrill invested surplus cash slated for “safe money-market-like investments authorized by City personnel” in three CDOs without disclosing the nature of these investments or evaluating whether the CDOs would be appropriate for Springfield. The city alleges that, when it requested that the securities be sold, it was told that auctions for them had failed and a sale could not occur. By the time the case settled in January, 2008, the value of the CDOs had fallen from almost \$14 million in mid-2007 to \$1.2 million.<sup>4</sup>

Several recent ARS cases relate to investments in the “Mantoloking CDO.” Two Bear Stearns hedge funds which collapsed in 2006 at one time invested in the CDO, and it has been specifically referenced in the following complaints:<sup>5</sup>

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<sup>1</sup> Jaime Levy Pessin, *Auction-Rate Securities Probed*, THE WALL STREET JOURNAL, April 8, 2008, at D3; Michael McDonald, *UBS, Merrill, Bank of America Auction Sales Probed (Update4)*, BLOOMBERG.COM, March 28, 2008, available at [http://www.bloomberg.com/apps/news?pid=20601213&sid=afRHj6\\_DfOCw&refer=home](http://www.bloomberg.com/apps/news?pid=20601213&sid=afRHj6_DfOCw&refer=home).

<sup>2</sup> Municipal Auction Rate Securities, SEC No-Action Letter (March 14, 2008), available at <http://www.sec.gov/divisions/corpfin/cf-noaction/2008/mars031408.pdf>.

<sup>3</sup> Rodrigue Ngowi, *Merrill Lynch agrees to settle Springfield investments dispute*, THE BOSTON GLOBE, Jan. 31, 2008, available at [http://www.boston.com/news/local/massachusetts/articles/2008/01/31/merrill\\_lynch\\_agrees\\_to\\_settle\\_springfield\\_investments\\_dispute/](http://www.boston.com/news/local/massachusetts/articles/2008/01/31/merrill_lynch_agrees_to_settle_springfield_investments_dispute/).

<sup>4</sup> *Id.*

<sup>5</sup> *Bear Bets Wrong*, BUSINESSWEEK, Oct. 22, 2007, cover story; see also Kevin LaCroix, *A Single “Toxic” CDO, A Multitude of Subprime Lawsuits*, THE D&O DIARY (March 9, 2008), available at <http://www.dandodiary.com/2008/03/articles/subprime-litigation/a-single-toxic-cdo-a-multitude-of-subprime-lawsuits/>.

**Filed October 18, 2007:**

*MetroPCS Communications, Inc. v. Merrill Lynch & Co., Inc. et al.*, Docket No: 07-12430 (116th Judicial District, Dallas County, Texas): MetroPCS alleges that Merrill Lynch invested its funds in ARS consisting of subprime-backed CDOs without informing it of the risks. In addition, MetroPCS alleges that Merrill failed to disclose its own stake in the CDOs, and responded to inquiries by misrepresenting the CDOs' vulnerabilities. According to the Complaint, almost \$20 million of MetroPCS's funds were placed in the Mantoloking CDO, and approximately \$114 million in other CDOs with subprime exposure. MetroPCS has filed claims for breach of contract, negligent misrepresentation, negligence, breaches of fiduciary duty, fraud, violations of the Texas Securities Act, and attorneys' fees.

**Filed February 20, 2008:**

*MIND C.T.I. Ltd. Arbitration*: MIND C.T.I. Ltd., which operates from Israel, Europe and the United States, recently filed a Statement of Claim with FINRA and began an arbitration against an unnamed "international bank" which invested \$20.3 million of its funds in the Mantoloking CDO. According to a Form 6-K filed with the SEC, the bank made the investment without informing MIND C.T.I., which expected its funds to be placed in liquid, low-risk securities. MIND C.T.I.'s claim includes allegations of fraud, negligent misrepresentation, breach of fiduciary duty, conversion, misappropriation, breach of contract, and securities violations.

The extent of MIND C.T.I.'s losses remains uncertain. In April, it issued a press release stating that the Mantoloking CDO had been downgraded to an A3 rating by Moody's, but remained AAA rated by Standard & Poor's. The company remarked that "[w]hile the liquidity of these investments has been significantly impacted by market conditions, we continue to receive interest payments every month. We are not able to predict whether conditions in the market for these securities will worsen or improve."<sup>6</sup>

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<sup>6</sup> Press Release, MIND C.T.I. Ltd., MIND CTI Updates on Company Held Auction Rate Securities (April 9, 2008), available at [http://www.marketwire.com/mw/rel\\_us\\_print.jsp?id=842165](http://www.marketwire.com/mw/rel_us_print.jsp?id=842165).