
Recent Developments in Auction Rate Securities Litigation

Beginning in 2007, problems began appearing in the \$300 billion Auction Rate Securities market. During 2007, some auctions failed for several closed-end funds offering preferred stock ARS backed by subprime debt. Then in February 2008, the ARS auction market failed on a large scale. More than 80% of the auctions scheduled for February 13 failed, and most of the auctions since then have also failed. So far, no secondary market of any substance has developed.

Auction Rate Securities fall into four principal categories: (1) preferred securities issued by closed-end mutual funds and backed principally by high quality instruments (“ARPS”), (2) securities backed by municipal bonds, (3) securities backed by collateralized debt obligations (“ARCS”), and (4) securities backed by student loans. As the per-share par value of these securities is quite high – \$25,000 in many cases – they are typically held by high net worth and institutional customers of brokerage firms. These clients will likely claim that they were sold as a low risk and liquid means to obtain an enhanced return above money-market rates. As such, many customers may have invested funds – in many cases in significant amounts – traditionally used to pay short term expenses.

All of these securities have been rendered at least temporarily illiquid by pervasive auction failures. Slowly, a very informal secondary market may be forming for some of the different types of securities. When, and whether, these securities regain their liquidity initially seems dictated by (i) credit risk and (ii) each security’s interest rate reset terms. Some securities – such as those backed by student loans – are currently viewed by some in the market as undesirable. Others, such as those backed by municipal bonds and which have interest rates now paying in the double-digits – seem highly desirable. So far, no movement has appeared in the ARPS market, but a few funds have redeemed a percentage of their preferred shares on a lottery basis.

The combination of these factors has implications for brokerage houses now faced with unhappy customers and potential allegations that these securities were inherently unsuitable given the purposes for which they were sold. The initial reactions to these problems, however, may complicate matters. Indeed, the immediate concern for many firms seems to be how to best assist good customers in satisfying their short-term cash needs. In some cases, brokerage houses are offering margin loans. In other cases, commercial banks with affiliated brokerage houses have stepped in to make short-term loans at interest rates that approximate the interest rates being paid by each customer’s ARS. In the event that some securities remain illiquid over the long term, or eventually are sold at values below par, such loans will likely not prevent investors from pursuing litigation to recover their losses.

The early lawsuits filed concerning these events involve allegations that investment banks were in some way responsible. For example, they have been accused of distorting the ARS markets by first preventing and then allowing failed auctions. In addition, they have been accused of failing to disclose their multiple roles to investors and of inadequately disclosing the risk of failed auctions. The Securities and Exchange Commission (SEC), the Financial Industry Regulatory Authority (FINRA), and the

Massachusetts Secretary of State are probing how ARS were marketed.¹ The New York Attorney General has subpoenaed 19 banks about ARS sales, and regulators in at least nine other states are investigating the securities.² In March, the SEC responded to some liability concerns by stating that it will 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.³

The majority of lawsuits filed so far have been brought by customers against brokers and brokerage houses. Many of these cases have been brought by the same law firms; for example, one firm has filed six auction rate securities lawsuits, another has filed four, and a third has filed ten.⁴ The allegations in these complaints are similar and include claims that the defendants knew, but failed to disclose, information about the liquidity of auctions and nature of ARS. An example is the Complaint brought against Goldman Sachs in the Southern District of New York:

Filed April 16, 2008:

Milch v. The Goldman Sachs Group, Inc., et al., Docket No. 1:08-cv-03659-JES (S.D.N.Y.): A customer who purchased ARS from Goldman Sachs has filed this class action under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934. The plaintiff claims that Goldman Sachs misled class members into believing that ARS were highly liquid, short term investments suitable for any investor with \$25,000 in cash willing to set aside funds for one week. However, according to the complaint, Goldman Sachs knew and did not disclose that the liquidity would last only for so long as broker-dealers continued to support the market. In addition, the plaintiff charges that Goldman Sachs failed to reveal that the auctions “were not governed by arm’s-length transactions but instead suffered from systemic flaws and manipulative practices,” such as permitting customers to change orders after auction deadlines and providing favored customers with inside information.

A more unusual complaint was filed in April against the Calamos Global Dynamic Income Fund, which originated preferred shares of auction rate securities, and the companies that underwrote those securities:

Filed April 21, 2008:

Miller v. Calamos Global Dynamic Income Fund et al. (S.D.N.Y.): The plaintiff in this class action alleges that the Calamos Fund issued a false and misleading registration statement and prospectus in connection with the offering of \$350 million of Auction Rate

¹ 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=afHj6_DfOCw&refer=home.

² InvestmentNews, *Here Come the ARS Lawsuits*, FINANCIALWEEK, April 22, 2008, available at <http://www.financialweek.com/apps/pbcs.dll/article?AID=/20080422/REG/323114373/1036>.

³ Municipal Auction Rate Securities, SEC No-Action Letter (March 14, 2008), available at <http://www.sec.gov/divisions/corpfin/cf-noaction/2008/mars031408.pdf>.

⁴ See <http://www.zlk.com/>; <http://www.girardgibbs.com/>; InvestmentNews, *supra* note 2.

Cumulative Preferred Shares. Specifically, the plaintiff claims that the Calamos Fund failed to disclose that the ARS market was not efficient, that auctions only succeeded because of the interference of broker-dealers, that interest rates paid to preferred shareholders if auctions failed would be less than the rates received by holders of municipal auction rate securities, and that the preferred shares would trade at a discount if markets failed. In addition, the plaintiff alleges that companies which underwrote the preferred shares failed to conduct adequate due diligence on the offering.

Many lawsuits combine allegations regarding auction rate securities with those involving subprime debt. A selection of these cases appears below.

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.⁵ 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.⁶

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:⁷

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 claims include allegations of fraud, negligent misrepresentation, breach of fiduciary duty, conversion, misappropriation, breach of contract, and securities violations.

⁵ Rodrique 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/.

⁶ *Id.*

⁷ *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/>.

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."⁸

⁸ 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.