



## Securities Law Alert

### A Litigation Department Publication

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### Auction Rate Securities: Opportunities for Corporate Investors to Recover

The collapse of the market for auction rate securities (“ARS”) left investors who thought they had a safe, liquid investment with illiquid securities. While there have been a number of government settlements with sellers of ARS, the agreements have focused on providing a recovery for small investors, leaving corporate and institutional purchasers of these securities to, essentially, pursue their own remedies. Nevertheless, there are meaningful opportunities for corporate purchasers of these securities to recover their investments. Prompt action is required.

#### **Background**

Auction rate securities, a type of derivative product whose value is derived from an underlying security such as preferred stock, bonds or student loans, had interest rates that were set at periodic auctions. These securities were marketed as cash equivalents that provided a safe, liquid investment with a good rate of return. Sellers claimed that ARS were essentially cash equivalents.

The trading practices of the banks and brokers that created and sustained the trading markets for these securities came under fire from the Securities and Exchange Commission (“SEC”) in 2006. The case did not address the sales claim (i.e., the representations that ARS were a cash equivalent). See Order, *In the Matter of Bear Stearns & Co., Inc., et al.*, Admin. Proceeding File No. 3-12310 (May 31, 2006). Although defaults began to appear in the ARS markets following the SEC settlement, banks and brokers continued to market the securities as cash equivalents until the ARS market crashed in February 2008. Suddenly, everyone realized what had been well known to Wall Street insiders: auction rate securities were not cash equivalents. At that point, however, ARS investors were left with illiquid investments and no immediate way to access their funds.

#### **The government settlements**

Beginning in August 2008, the SEC, the New York Attorney General and a number of other states entered into settlements with banks and brokers who sold auction rate securities. Typically, these settlements followed the pattern first established by the agreements in principle with Citigroup Global Markets, Inc. and UBS AG in August 2008. Those settlements focused on small retail investors and offered little assistance to corporate and institutional investors.

Under the terms of the Citigroup and UBS settlements, as well as several others, the banks and brokers typically agreed to: (1) repurchase auction rate securities from retail customers, charities and other small investors (“retail investors”); (2) resolve claims regarding consequential damages which may have been suffered by retail investors under special arbitration procedures set up by the Financial Industry Regulatory Authority (“FINRA”); and (3) use their best efforts to provide liquidity to the ARS market for large

investors. Based on this template, agreements have been executed with Bank of America Securities LLC, RBC Capital Markets Corporation, Merrill Lynch, Goldman Sachs, Deutsche Bank, J.P. Morgan, Morgan Stanley, Wachovia Capital Markets, BNY Mellon Capital Markets, Harris Investor Services, and City National Securities. While retail investors will be made whole under these arrangements, little in the way of meaningful relief is being provided to corporate and institutional investors.

### **Recovering your investment**

Corporate and institutional investors do have options for recovering their investment, despite being largely left out of the government settlements. These options include:

(1) *Hold to maturity*: Since auction rate securities are derivatives whose value is keyed to an underlying security, purchasers may, in some instances, elect to hold the securities until maturity. The viability of this option will depend on the nature of the underlying security. Typically, if there is a maturity date, it is years in the future. If the underlying security matures at some point, purchasers may elect to hold their position and redeem the securities on the maturity date. Many underlying securities do not mature, in which case this is not an option.

(2) *Trade the underlying security*: If the underlying security is a preferred stock, it may have more value if it is removed from the vehicle into which it was packaged as an auction rate security. To determine if it can be removed, the terms of the ARS should be reviewed in the first instance. The market value of the security should also be reviewed.

(3) *Class actions*: There are a number of class actions pending regarding auction rate securities. For example, actions have been filed against Citigroup, UBS AG, Bank of America Corporation, Deutsche Bank AG, E\*Trade Financial Corp., Merrill Lynch Corp., Morgan Stanley, Oppenheimer Holdings, Inc., Raymond James Financial, Inc., Royal Bank of Canada, TD Ameritrade Holding Corp., Wachovia Corp., and Wells Fargo & Co. Purchasers may consider monitoring these actions and, at the time of settlement, determining whether to participate or opt out (if their holdings are covered by the class action). Since most class actions recover relatively small amounts for investors, purchasers of ARS are not likely to secure a meaningful recovery through this option.

(4) *Private actions*: Purchasers can elect to file their own private action against the bank or broker who sold the security and perhaps others. Purchasers may first be required to arbitrate any claim because brokerage firm account documents typically contain a mandatory arbitration provision. However, many auction rate securities were sold by financial institutions or their subsidiaries through accounts that do not require arbitration. In that instance, the purchaser may elect to pursue an action in either federal or state court based on, respectively, the federal securities laws or state securities statutes with additional common law claims. In some instances, it may be more advantageous to pursue state law remedies that are not burdened with the stringent pleading and procedural limitations of federal actions. Common law claims can also provide a good vehicle for recovery since the claims may be easier to prove if, for example, they can be based in negligence rather than intentional fraud. A careful assessment of these remedies should be made in each instance.

(5) *Lehman*: The parent of Lehman Brothers, a firm that was very active in the ARS market, filed for bankruptcy. Lehman Brothers is also the subject of a Securities Investor Protection Corporation ("SIPC") liquidation. Purchasers who acquired auction rate securities from Lehman should carefully evaluate whether they should file a claim in these proceedings.

Corporate and institutional investors who purchased auction rate securities based on claims that they were cash equivalents may have meaningful options for recovering their investment at the present time. To preserve and exercise those rights, a careful evaluation should be made of the securities purchased in view of the options outlined above, as well as the circumstances surrounding the transactions. That evaluation should be completed as soon as possible to preserve all rights and opportunities for recovery.

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