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2008 ARS Fallout: The Last Wave?

Law360, New York (November 03, 2008) -- As the credit crisis on Wall Street unfolds in dramatic new ways, last winter's failures in the auction rate securities market have resulted in a series of government investigations, dramatic settlements and innovative class actions against the underwriters and distributors of these securities. In February 2008, the \$330 billion market for auction rate securities ("ARS") nearly shut down.

After decades of successful auctions, February saw hundreds of auctions fail as the ARS market ground almost to a standstill.

This freeze, in which many ARS purchasers found themselves suddenly unable to sell these securities, has given rise to scores of private lawsuits as well as a raft of state and federal government investigations that have culminated in a series of remarkable settlements.

The First Wave: The Government Investigations And Settlements

Investigations by the SEC and state regulators began as early as late February. State investigators quickly agreed to coordinate their efforts through the North American Securities Administrators Association ("NASAA") and organized a national ARS Task Force chaired by Bryan Lantagne, Director of the Massachusetts Securities Division.

Task force members include investigators from Florida, Georgia, Illinois, Massachusetts, Missouri, New Hampshire, New Jersey, North Carolina, Texas, and Washington. See NASAA News Release 041708 (April 17, 2008).

The Task Force, the SEC, and New York Attorney General Andrew Cuomo have taken the lead role in investigating and prosecuting investment firms that marketed ARS.

The conduct underlying the government investigations stems from the underwriters' alleged marketing of ARS to many of their customers as "highly liquid" investments.

The SEC asserts that the lead underwriters misrepresented the ARS to their customers as “money market investments” or “cash alternatives” when in fact their liquidity was premised on the underwriters providing supporting bids for auctions, and that when the underwriters stopped supporting auctions in February 2008, the investors were stuck holding the illiquid securities.

The settlements began in August 2008 and to date, the underwriters that had underwritten and marketed these ARS have agreed to repurchase over \$80 billion in ARS and to pay over \$500 million in fines.

SEC Chairman Christopher Cox has described the four largest settlements (Citigroup, UBS, Wachovia and Merrill Lynch) as “the largest settlements in the history of the SEC.” Testimony Before the Committee on Banking, Housing, and Urban Affairs, United States Senate (Sept. 23, 2008), sec.gov/news/testimony/2008/ts092308cc.htm.

The first of these settlements (which are subject to final documentation and approval) was negotiated with Citigroup. Citigroup agreed to repurchase or use its best efforts to repurchase all of the \$19.5 billion in ARS Citigroup customers were holding as of February 2008.

Specifically, the agreement provides that out of the \$19.5 billion of ARS sold, Citigroup will liquidate at par all ARS from its retail customers within three months of the settlement, totaling some \$7.5 billion.

Citigroup will use its best efforts to liquidate the remaining \$12 billion of ARS sold to institutional investors by the end of 2009.

Citigroup also agreed to a permanent injunction against violating Section 15(c) of the Exchange Act, which prohibits the use of manipulative devices by broker-dealers; to provide no-cost loans to customers until their securities are repurchased; to reimburse customers for any interest costs incurred; to liquidate customers’ holdings before selling its own inventory of ARS; and to participate in an arbitration process overseen by the Financial Industry Regulatory Authority (“FINRA”) to address any consequential damages suffered by customers.

Additionally, Citigroup agreed to pay \$50 million in penalties to New York and \$50 million to the NASAA.

Using the Citigroup agreement as a model, other major financial institutions soon followed suit and struck dramatic settlements of their own, including Bank of America (\$4.7 billion for retail investors, \$5.0 billion for institutional investors), Credit Suisse (\$548.0 million for retail investors), Fidelity Investments (\$300.0 million for retail investors), Goldman Sachs (\$1.5 billion for retail investors), JP Morgan (\$3.0 billion for retail investors), Merrill Lynch (\$10.0 billion for retail investors, best efforts for institutional investors), RBC Capital Markets (\$800.0 million for retail investors, best efforts for institutional investors), UBS (\$8.3 billion for retail investors, \$3.5 billion for

holders of tax-exempt ARS, best efforts to return \$10.3 billion to institutional investors), and Wachovia (\$5.7 billion for retail investors, \$3.1 billion for institutional investors).

These institutions also agreed to pay fines and penalties ranging from \$15.0 million (Credit Suisse) to \$150.0 million (UBS), including a \$125.0 million fine to Merrill Lynch.

Of course, the amounts the underwriters are paying in these settlements do not reflect their actual cost to the underwriters, since they are receiving ARS in exchange for their payments.

The true cost to the underwriters is the difference between the par value and the market value of the ARS they are repurchasing, which is likely to be a very small fraction of the amounts set forth above. W

What is remarkable about these settlements, however, is that there is virtually no compromise. The underwriters and brokers have agreed to make retail investors whole for virtually all purchases of ARS through the settling parties.

“Nobody Gets a Pass”: The Fate Of Regional Brokers In The ARS Government Settlements

Despite the extensive reach of these settlements with the large brokerage firms, one category of ARS has so far only begun to be addressed: ARS sold by smaller, regional securities firms. An initial series of settlements was announced on Sept. 18 with the smaller regional brokers. FINRA announced that it had reached agreements with SunTrust Investment Services, Sun Robinson Humphrey, Comerica Securities, First Southwest Company, and WaMu Investments.

As part of the settlement, each firm agreed to repurchase all ARS it sold to individual investors and some institutions between May 31, 2006 and February 2008.

Additionally, the firms agreed to pay substantial fines: Sun Robinson, \$1.65 million; Comerica, \$750,000; SunTrust, \$300,000; First Southwest, \$300,000; and WaMu, \$250,000.

These settlements with regional brokers may be just the beginning. The Regional Bond Dealers Association (“RBDA”) estimates that approximately \$60 billion of the roughly \$160 billion of outstanding ARS are not covered by the existing settlement agreements.

The RBDA is not advocating that all regional brokers strike similar deals. Rather, the RBDA has urged the SEC, the ARS Task Force and the New York Attorney General to expand the scope of their settlements with the large underwriters to include ARS that were sold directly by regional brokers, which the RBDA describes as “distributing firms.”

The RBDA argues that although these firms sold ARS to investors, they did not participate in the ARS auctions (or did so only to a limited extent) and had, at best,

limited access to information regarding the deteriorating liquidity conditions in the ARS market in late 2007 and 2008.

It argues that the lead managers in an ARS transaction exercise “an almost complete degree of control” over information associated with auctions and that to the extent the lead managers conveyed a false sense of liquidity, the distributing firms were deceived along with investors. See Letter from the RBDA to Christopher Cox, Chairman of the SEC; Karen Tyler, North Dakota Securities Commissioner and President of NASAA; and New York Attorney General Andrew Cuomo, www.regionalbonddealers.com/pdf/RBDA_ARS_Letter_2.pdf.

So far, the SEC and other government investigators have not adopted the RBDA’s view, but instead are probing the distributing firms as well. As noted above, five of these firms have already settled with FINRA.

“Secondary dealers, other primary dealers that aren’t part of the settlements, are being investigated,” SEC Chairman Christopher Cox warned in late August 2008. “Nobody gets a pass.” Andrew Ackerman and Lynne Funk, Cox: All ARS Dealers Scrutinized, *The Bond Buyer*, Aug. 20, 2008, www.bondbuyer.com/article.html?id=200808194U173JEG.

Given the investigators’ apparent determination to pursue the regional firms, coupled with those firms’ position that they were duped by the lead underwriters, a potentially significant new wave of litigation may consist of actions by regional firms seeking to recoup their settlement payments and other losses from the lead underwriters they claim misled them.

Whether such a wave will materialize still remains to be seen.

The Second Wave: Private ARS Class Actions

The first tranche of private actions began in March 2008, after the government investigations began but before any settlements had been announced.

These were federal securities law class actions on behalf of purchasers of ARS, alleging that the underwriters that marketed the ARS misrepresented them to investors as safe, liquid cash alternatives. E.g., *Miller v. Morgan Stanley & Co.*, No. 08 CV 3012 (AKH) (S.D.N.Y. filed March 21, 2008); *Waldman v. Wachovia Corp. et al.*, No. 08 CV 2913 (SAS) (S.D.N.Y. filed March 19, 2008).

Even before these early suits have made any headway, however, the dramatic government settlements have largely taken the wind out of their sails.

That is because the settlements have swept most of the investors’ damages out from under them. The underwriters’ agreements to repurchase the ARS should address plaintiffs’ allegations that they were stuck with worthless, illiquid securities.

Although plaintiffs' attorneys have argued that these settlements will not fully compensate investors and have vowed to continue to pursue their private actions (see "Bank of America in \$4.5 Billion Auction-Rate Settlement," *American Lawyer* (September 11, 2008)), plaintiffs in the current actions could be left with only insignificant damages.

These settlements, however, did not put an end to the private litigation. Instead, they have given rise to another wave of private actions that is not dependent on damages calculated by the losses suffered by purchasers of ARS.

The Third Wave: The Derivative Suits

In August 2008, a number of derivative actions were filed against ARS underwriters, purportedly on behalf of the very institutions that sold the ARS and that allegedly misled investors.

So far at least seven of these actions have been filed in the Southern District of New York against Goldman Sachs, Morgan Stanley, Merrill Lynch and Citigroup. E.g., *Louisiana Mun. Employees Ret. Sys. v. Goldman Sachs Group Inc. et al.*, No. CV 7605 (S.D.N.Y. filed Aug. 28, 2008); *Thomas v. Morgan Stanley & Co. et al.*, No. 08 CV 7951 (GEL) (S.D.N.Y. filed Sept. 12, 2008); *Louisiana Mun. Employees Ret. Sys. v. Merrill Lynch & Co. et al.*, No. CV 7618 (S.D.N.Y. filed Aug. 28, 2008); *Louisiana Mun. Employees Ret. Sys. v. Citigroup Inc. et al.*, No. CV 7389 (S.D.N.Y. filed Aug. 20, 2008).

In addition to the standard derivative suit claims, including causes of action for breach of fiduciary duty, these suits purport to assert federal securities law claims under Section 10(b) and Rule 10b-5 on behalf of the underwriters against their own current and former officers and directors.

Plaintiffs allege a vast conspiracy within each firm, from the CEO to individual directors on down to, in some cases, individual research analysts and traders, to create and support a market for ARS by falsely claiming that ARS are liquid.

Plaintiffs allege that in order to protect the underwriters' profits on the ARS and to enhance the individual defendants' positions and compensation, the defendants manipulated and deceived the ARS market until February 2008, when the music stopped.

Plaintiffs further allege that this dramatic crisis led to high-profile investigations, which have damaged the underwriters in the form of costly settlements, fines, and harm to their reputations for honesty and integrity. Plaintiffs purport to seek compensation on behalf of the underwriters.

Specifically with respect to the 10b-5 claims, plaintiffs allege that in repurchasing their own stock, each underwriter "or its shareholders" relied on the defendants' statements and the integrity of the market.

Plaintiffs allege that the underwriters suffered and will suffer an unspecified amount of damages in that they paid artificially inflated prices for their own stock purchased on the open market.

It sounds great (for plaintiffs, at least), but does it work?

In addition to the standard derivative action hurdles (e.g. the demand requirement, etc.), these derivative claims raise a number of significant questions, not the least of which is whether they are truly seeking damages suffered by the firms, as they are required to do, or if these suits are another way of attempting to recover damages actually suffered by shareholders.

E.g., Ralph C. Ferrara et al., Shareholder Derivative Litigation Besieging the Board § 1.02(2) (2003)("[A] derivative suit is not brought by shareholders as individuals seeking redress for injury caused to them personally, but as representatives of the corporation seeking redress on behalf of the company for harm caused to it."

Therefore, "[a]n action brought by a shareholder for harm done exclusively to that person must proceed as a direct action by the individual (or class of individuals) against the purported wrongdoers regardless of how the action is initially styled."

The decision by plaintiffs in the derivative suits to assert securities fraud claims raises another significant issue. The allegations in these cases that all the underwriters' directors and senior management were complicit in the alleged ARS fraud arguably leaves no decision-maker at the company to have relied on the fraud in deciding to cause their companies to repurchase stock.

As a matter of federal securities law, can a corporation prove that it "relied" on its own allegedly false statements and omissions when its directors, top management and key employees were all aware of the supposed fraud? At least one court has held recently that it may not. VeriSign, Inc. Derivative Litig., 531 F. Supp. 2d 1173, 1209 (N.D. Cal. 2007).

Interestingly, although plaintiffs in the derivative suits have asserted derivative 10b-5 claims on behalf of the brokers against their officers and directors, one type of action the courts have not seen are class actions asserting those same claims directly on behalf of the brokers' shareholders.

One reason may be that none of the brokers' stocks appears to have had any significant reaction during the first week of August 2008, when plaintiffs allege the truth came to light, so that the shareholders are unable to allege that the alleged omissions caused them any loss.

It is doubtful that we have seen the last wave of ARS lawsuits. As the current suits run afoul of circumstances (such as the massive government settlements) and defenses

(such as the arguable lack of reliance on their derivative 10b-5 claims), plaintiffs' legal theories will likely continue to mutate and adapt.

In fact, two recently filed suits have already suggested a possible new third wave: Brought on behalf of a putative class of issuers of ARS, they claim that as the market began to falter, all the underwriters acted collusively to maintain and stabilize the market and then, in a coordinated boycott, simultaneously refused to continue to support the auctions, all in violation of section 1 of the Sherman Act.

Plaintiffs claim that as a result of the alleged violations, issuers are stuck paying the higher default rate of interest on the securities they issued. E.g., *Mayor and City Council of Baltimore, MD v. Citigroup, Inc. et al.*, No. 08 CIV 7746 (S.D.N.Y. filed September 4, 2008).

Given the creativity of the plaintiffs' class action bar, it is unlikely that these waves will stop crashing anytime soon.

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