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THE COLLAPSE OF THE AUCTION RATE SECURITIES MARKET

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In the past year or so, individual investors have faced some bitter disappointments. Some of the most distasteful were experienced by people who bought auction rate securities ("ARS"). Many of the investors in these securities thought that they were buying something comparable to a money market fund or a similar cash equivalent. Indeed, ARS often were marketed in just that way. But ARS did not turn out to be cash equivalents — a fact that became all too apparent when the ARS market suddenly and utterly collapsed in February 2008.

At that time, the market for ARS froze. Buyers of those securities suddenly found themselves trapped in long-term investments that sometimes offered a low rate of return and had no escape hatch. The good news is that, beginning in late 2008, largely as a result of pressure from the Securities and Exchange Commission, many of the investment banks that issued these securities repurchased them from retail customers at face value. The bad news is that there are still a lot of investors who are stuck with some of the worst performing ARS. This article will provide a basic explanation of what ARS are and how they work. It will also describe the allegations made in a well-publicized case brought after the ARS markets collapsed, and will outline briefly some of the legal options that buyers of these securities may have available to them.

What Are Auction Rate Securities?

ARS were first introduced in the 1980s. They are bonds or preferred stocks that pay interest or dividends at rates of interest that vary and that are set at auction. The bonds are long term, generally maturing in 20 to 30 years. The preferred stocks are equity investments and, as such, they are perpetual.

Auction Rate Securities as financial investments had their origin in the need for cities to finance long-term, capital intensive projects. Typically, municipalities issued long-term municipal bonds, with fixed interest rates, to finance such projects. Bankers and underwriters created the Auction Rate Certificate ("ARC"), the forerunner of today's ARS, in an effort to find a cheaper source of municipal financing. Sean T. Seelinger, *Auction Rate Securities: A Fast & Furious Fall*, 12 North Carolina Banking Institute 287 (March, 2009); Melanie Cherdack, *et al.*, *Auction Rate Securities: The New Frontier* (Practicing Law Institute, Aug. 6, 2008); Stephanie Lee, *Auction-Rate Securities: Bidder's Remorse?* (NERA Economic Consulting, May 6, 2008).

The ARC, like a traditional municipal bond, was a long-term municipal debt. It differed from traditional long-term municipal bonds, however, in that it paid a short-term interest rate that was set at periodic "Dutch" auctions. Although these then-new investments offered lower interest rates than traditional long-term municipal bonds, they had the advantage of being relatively liquid assets because they were sold frequently at auctions. Moreover, if there were no buyers for the ARCs at the auctions, then typically the interest rate on the ARCs would be reset to a default "penalty" rate that was competitive with traditional long-term bonds or even higher. This gave issuers strong financial incentives to redeem (or buy back) the ARCs if or when an auction failed. Cherdak, *et al., supra*. The default rate protected investors by maintaining the liquidity of their investment and/or by paying them a higher rate of interest if the issuer did not redeem the ARC.

Eventually, investment bankers created a variant of the ARC — sometimes called Auction Rate Preferred or Auction Preferred Shares (collectively, called "ARS" herein). Like ARCs, the interest rates payable on ARS were set at Dutch auctions that occurred at periodic intervals, often as frequently as every 7 days. Seelinger, *supra*; Cherdak, *et al., supra*.

However, the "penalty" interest rate that applied if an ARS auction failed was not always set at or above the market rate for long-term debt. Instead, such rates could be far lower. Thus, unlike some of their ARC counterparts, the issuers of some ARS did not have as strong a financial incentive to redeem ARS in the event of an auction failure.

ARS appealed to issuers, including many municipalities, because ARS offered them the ability to obtain long-term money at short-term interest rates. ARS attracted buyers because they paid an interest or a dividend rate that generally was higher than that available from a money market fund and, because of the constant auction process, seemed to offer continuing liquidity. Seelinger, *supra*; Cherdak, *et al., supra*.

How Did the Auctions For These Securities Work?

ARS were issued pursuant to offering documents. Thereafter, they could be bought and sold on the secondary market. Investment banks often made a market in these securities and sometimes bought and sold them for their own account. In addition, they, along with broker-dealers, often ran the periodic Dutch auctions at which ARS were bought and sold. Seelinger, *supra*; Lee, *supra*.

There are many variants of the Dutch auction, but the basic idea is to sell a complete lot of fungible items to multiple bidders at the same auction-determined price. Alan J. Berkeley, *Some Background and Simple FAQs About Dutch Auctions and the Google IPO, Fundamentals of Securities Law* (ALI-ABA Course of Study, April 30, 2009). The rules for these auctions often were complex but, for our purposes, the following explanation will suffice.

At the Dutch auctions, ARS buyers submitted bids for the dollar amount of the ARS they wanted to buy at the minimum interest or dividend rate that they wanted to receive. Sellers offered their ARS for sale at the auction price. The interest or dividend rate that was set was the *lowest* interest or dividend rate that was necessary for *all* of the ARS offered for sale at that auction to be sold. This was called the "clearing rate." Seelinger, *supra*; Cherdak, *et al., supra*; Berkeley, *supra*.

As a simple illustration, suppose that 10 million dollars worth of identical bonds were offered for sale at Dutch auction for ARS, and there were five bidders as follows:

ARS Dutch Auction

Bidders	Dollar Value of ARS Sought	Interest Rate Sought
A	5 Million	2.5%
B	4 Million	2.6%
C	2 Million	2.7%
D	2 Million	2.7%
E	2 Million	3.0%

As shown above, A bid for 5 million dollars worth of bonds at 2.5% interest; B bid for $4 million at 2.6% interest; C and D each bid for $2 million of bonds at 2.7% interest; and E bid for $2 million of bonds at 3% interest. The clearing rate for this auction would be 2.7% interest — the lowest interest rate necessary for all of the bonds to be sold. This rate would be paid on all of the bonds until the interest rate was reset at the next auction. (In this example, A would get $5 million worth of the bonds, B would get $4 million, C and D each would get $500,000, and E would get none.)

The ability to sell one's ARS depended on there being enough buyers at the auction to purchase all of the ARS that were offered for sale. If the amount of ARS for sale exceeded the amount that purchasers were willing to buy, then the auction failed. When an auction failed, the default rate (the "Default Rate") of interest set forth in the original offering documents for the ARS generally would apply. Seelinger, *supra*; Cherdak, *et al., supra*; Berkeley, *supra*.

What Happened To The Market For ARS

The auctions for ARS appear to have worked well for a number of years. From time to time, the ARS issued by a particular entity became less desirable due to that entity's credit or other problems and correspondingly more difficult to sell, but those situations seem to have occurred infrequently and there appears to have been no systemic problems with ARS liquidity. It is unclear when this began to change. However, some people have suggested that the market became dramatically less fluid in or around the summer of 2007, as credit markets tightened. Although there were a number of ARS auction failures in 2007, however, the ARS market continued to function until mid-February 2008, when it suffered a wholesale and abrupt collapse. Seelinger, *supra*; Cherdak, *et al., supra*; Lee, *supra*.

While only thirteen auctions failed between 1984 and 2006, and only thirty-one failed during the second half of 2007, eighty-seven percent of the nearly 400 daily auctions failed on February 14, 2008. In effect, the market for auction-rate securities disappeared overnight. Investors who believed that they were holding liquid cash-equivalent securities suddenly found themselves holding illiquid, long-term securities with few, if any, redemption options. Seelinger, *supra*; Lee, *supra*.

Since that time, there has been a flurry of criminal proceedings, civil suits and other investigative activity. Seelinger, *supra*. One such case, an action brought by New York's attorney general, Andrew Cuomo, is described next.

Anatomy of An Alleged Scheme — Cuomo's Case Against UBS

There have been a number of actions taken against those who marketed and sold ARS to retail investors. Many of them involve stories similar to the allegations made by New York's attorney general, Andrew Cuomo, in the case his office brought against UBS Securities LLC and UBS Financial Services, Inc. (collectively, "UBS"). Allegations made in that complaint ("UBS Complaint") assert that UBS was the sole manager or lead manager of a large number of ARS issued by municipalities, student loan organizations, and closed-end mutual funds. The Complaint also alleges UBS and its trading desk were the "point of contact" for investors and broker-dealers who wanted to buy or sell ARS. According to the Complaint, UBS was paid a fee by ARS issuers for the services it provided, including managing auctions at which ARS were bought and sold. UBS Compl. ¶18.

Allegedly, UBS from time to time participated in these ARS auctions by placing bids for its own account. These so-called "support bids" allegedly were used to prevent an auction from failing by assuring that there were enough buy orders to purchase all of the ARS for sale at a particular auction. The Complaint alleged that from January 2006 onward, the ARS market in which UBS participated could not have functioned without UBS support. But, the Complaint said, UBS investors "could not determine if auctions were succeeding because of normal marketplace demand, or if UBS was propping up auctions through support bids." *Id.*, ¶¶20-23.

According to the Complaint, when UBS purchased ARS through support bids, it became the owner of those ARS and this, in turn, put UBS at an ever-increasing risk of loss if ARS auctions failed. Indeed, the Complaint alleged that UBS became increasingly concerned during 2007 that the ARS market could collapse, putting UBS at risk for the ARS that UBS allegedly acquired as a result of propping up ARS auctions though its support bids. *Id.*, ¶¶1-9, 23-26, 53-85.

The Complaint also alleged that late in 2007, UBS became increasingly concerned about the long-term viability of the ARS market and embarked on a plan to sell off the ARS that it had acquired through its support bids. Thus, according to the Complaint, UBS began aggressively marketing ARS so that it could reduce its ARS inventory, and its sales efforts accelerated in late 2007 as it became increasingly concerned that ARS auctions would begin to fail. *Id.*

The Complaint said that although UBS was aware of the liquidity risks posed by ARS auction failures, its sales teams did not inform clients of those risks. Indeed, according to Attorney General Cuomo's office, UBS and its sales agents continued to market ARS as "safe, highly liquid, and cash-equivalent securities." Press Release, Office of the New York State Attorney General Andrew M. Cuomo, Attorney General Cuomo Brings National Multi-Billion Dollar Lawsuit Against UBS For Auction Rate Securities Scandal (July 24, 2008) (the "Press Release").

In the end, UBS and some of its executives purportedly off-loaded millions of dollars worth of ARS to investors who, according to the Attorney General's office, had been deceived by UBS and its sales agents into thinking that the ARS were safe investments that investors could liquidate in a very short time. UBS Compl., *supra*, ¶1-9; Press Release, *supra*.

Post-Collapse Fallout And Investors' Options

As noted before, a host of governmental investigations, lawsuits, and even criminal proceedings have followed in the wake of the sudden collapse of the ARS market. As a result, a number of issuers and broker-dealers have either been forced, or have agreed, to essentially repurchase the ARS they sold to retail investors. Thus, at least some ARS investors have been made more or less whole as a result of these actions. Unfortunately, these investors make up a fraction, albeit sizable, of the $330 billion ARS market that suddenly became illiquid in February 2008. Left in the lurch are many investors who purchased ARS from institutions that have not yet been the focus of governmental actions and which, in many instances, may not have the capital to buy back all of the ARS that they sold. Seelinger, *supra*.

Wait and See

Some investors have chosen simply to wait and see what happens. For some, this strategy has worked. For example, some issuers have agreed to repurchase the ARS they sold (at least in part, and at least for certain types of investors), which has gone a long way to make certain of their investors whole. Seelinger, *supra*. Other investors have thus far not been so fortunate. They may continue to wait. If they do so, they too may ultimately have their ARS repurchased by the seller and, in the meantime, they probably will continue to receive the interest payable by the ARS. The ARS market also may rebound at some time in the future, returning ARS to liquidity. Many investors, however, will not be happy with this option, especially if what attracted them to ARS in the first place was the representation that an ARS was a liquid "cash equivalent." Moreover, taking the wait and see approach puts investors at risk of forfeiting legal claims they may have under applicable statutes of limitations or other grounds.

Take Part In Or File A Class Action

Investors may already be eligible to participate in one of the class action lawsuits pending against those who sold ARS. If not, they might consider bringing such an action themselves. A few examples of the types of legal claims that typically are brought in such suits are described briefly later in this article. But there are a couple of things to keep in mind when considering bringing or participating in a class action.

Filing or joining a class action suit has some advantages. For one thing, a class action permits plaintiffs to aggregate claims that may be too small — on their own — to justify bringing an individual lawsuit. For another, class action suits tend to get the attention of defendants. As the old saying goes, there is "strength in numbers." Moreover, discovery is typically more extensive in class action litigation, which can be very important in helping plaintiffs develop their cases. There are also disadvantages, however, in bringing or participating in a class action.

First, class-action lawsuits may take longer to resolve than individually brought suits, particularly because defendants often relentlessly oppose class certification. So, this option may not be attractive unless the investor can wait for any ultimate recovery. *Second*, when one participates in a class action, one typically has little or no control over the course of the litigation. *Third*, the possibility of a lawsuit, of any kind, might be limited because the contracts that investors typically sign with their brokers or financial advisors often require disputes to be arbitrated.

File An Arbitration

As we just observed, a number of investors wishing to resolve their ARS disputes might be contractually obligated to arbitrate their dispute. Such arbitration usually occurs before the Financial Industry Regulatory Authority ("FINRA"), which typically has jurisdiction over the brokers and firms that sold ARS. Arbitration may have some advantages over litigation, because it generally is faster and less expensive. On the other hand, arbitration usually provides for much less discovery than litigation, particularly from third parties, and that may be a problem for investors who need a lot of discovery to uncover the evidence needed to prove their case.

What Kinds of Claims Do Investors Potentially Have?

As the summary of the UBS Complaint suggests, most investor's claims are based on the premise that they were deceived or misled about the nature of ARS. The most typical claim is that ARS were marketed to them as safe, liquid (*i.e.*, "cash equivalent") investments, even though those that marketed them knew or should have known that this was not the case. In appropriate cases, some investors also may wish to assert that the persons who sold ARS concealed the fact that ARS markets had been made to appear as safe, liquid markets only through clandestine efforts to prop up the markets, as Attorney General Cuomo alleged had been done in the UBS case. A thumbnail outline of some of the types of legal theories investors may be able to assert is described next.

Federal Securities Fraud Claims

Investors who believe they may have been deceived as outlined above may be able to bring a claim under Rule 10b-5, promulgated under the Securities Exchange Act of 1934 (a "10b-5" claim). *See generally* Paul Vizcarrondo, Jr. and Andrew C. Houston, *Liabilities Under Sections 11, 12, 15 and 17 of the Securities Act of 1933 and Sections 10, 18 and 20 of the Securities Exchange Act of 1934* (Practising Law Institute 2006) ("Vizcarrondo and Houston"). Claims under Rule 10b-5 are derived largely from common-law fraud principles and would be based on the theory that those who sold the ARS intentionally misrepresented that ARS were cash equivalents when the sellers knew they were not. In addition, depending on the circumstances, plaintiffs might also be able to allege that the ARS seller concealed the fact that the ARS market appeared stable *only* because market-makers deliberately intervened to keep ARS auctions from failing.

Rule 10b-5 claims, however, are difficult to plead and prove. Among other things, plaintiffs must prove that those selling the ARS essentially knew they were lying when they said that ARS were "cash equivalents." This presents a considerable challenge. Given that few ARS auctions failed before the 2008 crash, some ARS sellers — and perhaps many of them — may have honestly believed that ARS were "cash equivalents." If so, then a Rule 10b-5 claim probably would fail. *SEC v. Infinity Group Co.*, 212 F.3d 180, 191-92 (3rd Cir. 2000).

Plaintiffs also must show that they reasonably relied on their broker's advice. *Tirapelli v. Advanced Equities, Inc.,* 215 F. Supp. 2d 964, 970 (N.D. Ill. 2002). This, too, could be tricky, particularly when the plaintiff was a sophisticated, long-term, ARS investor, who may have — or arguably should have — known the risks of investing in ARS. Causation is also a potentially difficult issue as defendants are sure to argue that it was the seizing up of the credit markets in general, and not any particular characteristic of ARS, that caused the ARS auctions to fail.

Plaintiffs have a number of remedies available to them in a Rule 10b-5 claim. Chief among them: (a) their "out of pocket" losses, that is, the difference in value between the ARS (as it was represented to be) and the ARS (as it actually was); or alternatively (b) rescission of the transaction in which they purchased the ARS. Vizcarrondo and Houston, *supra*.

For many ARS investors rescission is an attractive remedy because it avoids problems of proving their out-of-pocket losses and returns their money.

Punitive damages are not available to Rule 10b-5 plaintiffs, nor can they generally recover their attorney's fees. Vizcarrondo and Houston, *supra*; *Flood v. Miller*, No. 98-35584, 2002 WL 1135932 (9th Cir. 2002). Plaintiffs generally must bring their 10b-5 claims within two years after the discovery of facts constituting the violation but not later than five years after their purchase. Vizcarrondo and Houston, *supra*.

STATE LAW CLAIMS

Common-Law Fraud

As noted above, Rule 10b-5 claims and common-law fraud claims are similar. Thus, plaintiffs considering a Rule 10b-5 claim will almost certainly want to consider a common-law fraud claim as well. However, two differences are worth mentioning. *First*, punitive damages are available for common-law fraud claims, unlike Rule 10b-5 claims. *Gomez v. The Finishing Co.*, 369 Ill. App. 3d 711, 721-22 (1st Dist. 2006). *Second*, limitations periods for common-law fraud claims vary from state to state.

Breach of Fiduciary Duty

Under the common law of many states, brokers may owe fiduciary duties to their investor clients if they exercise discretion over the investment of their client's funds. These duties generally include the duty of utmost honesty and good faith with respect to their clients, as well as the duty to study and understand investments prior to recommending them to their clients. *McAdam v. Dean Witter Reynolds, Inc.*, 896 F.2d 750, 767 (3rd Cir. 1990); *De Kwiatkowski v. Bear, Stearns & Co.*, 306 F.3d 1293, 1302 (2nd Cir. 2002); *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 952-53 (D.C. Mich. 1978). Brokers who deliberately misinform their clients about the nature of their investments, breach these duties. Brokers who told their clients that ARS were "cash equivalents" may have breached this duty if they did not study or understand ARS prior to making such a statement. A plaintiff who can prove that he suffered damages as a result of inaccurate advice may have a sound case. Punitive damages may be available on these claims, but legal fees generally cannot be recovered. *Kirkpatrick v. Strosberg*, 385 Ill. App. 3d 119, 133 (2nd Dist. 208). Limitations periods vary from state to state.

Violation Of A Consumer Fraud/ Deceptive Practices Act

A number of states have enacted laws that protect consumers from manipulative, deceptive or misleading practices committed in business transactions. Some of these statutes have been held to apply to the sale of investments and these may apply to ARS cases. *Wafra Leasing Corp. v. Prime Capital Corp.*, 247 F. Supp. 2d 987 (N.D. Ill. 2002). Sometimes, these statutes permit a consumer to recover for a seller's misrepresentation without having to prove that the seller knowingly or intentionally did anything wrong. In addition, some of these statutes provide that successful plaintiffs may recover the attorney's fees they spent in pursuing their rights. *E.g.*, 815 ILCS 505/10a(c). They also may provide for punitive damages. Limitations periods vary from state to state.

What Are My Chances of Success?

It is impossible to predict a claimant's chance of succeeding on one or more of the theories described above without knowing the facts and circumstances of each ARS investment. A claimant's chances of success generally will be higher if, for example, he or she bought ARS early in 2008 (when many in the ARS industry began to question whether ARS investments were as good as "cash"), informed his broker that he needed a liquid investment, and explicitly was told that ARS were "cash equivalents." It should be remembered, however, that any ARS claim will present significant legal and factual hurdles. Given the long-term and relatively uninterrupted history of successful ARS auctions, it may be that many sellers of ARS genuinely believed — and had reason to believe — that ARS were "cash equivalent" investments.

Conclusion

Despite the considerable efforts that the SEC and various state officials have taken to require certain financial institutions to buy back the ARS that they sold, there are still a great number of investors who are stuck with ARS that they cannot sell (except, perhaps, at a great loss) and on which they may be earning only a paltry rate of return. Such investors should consider their legal options and recognize that, if they wait too long before taking action, they may lose some or all legal remedies and subject themselves to further financial losses.

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