

Auction Rate Securities: Survey of Potential Remedies

Katherine K. Bruce, Esq.
Richard R. Zabel, C.P.A.

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On February 13, 2008, the estimated \$350 billion auction rate securities market collapsed. The collapse left investors unable to liquidate an investment that most had originally chosen based upon its characterization as highly liquid, short-term, safe, and as a cash-equivalent. Given the current financial environment where access to cash can be essential, and given the fact that many of those who invested in auction rate securities (“ARS”) did so as a money-management tool driven by liquidity considerations, this illiquidity has left many investors, particularly corporate/institutional investors, in a highly problematic situation.

ARS are debt instruments in the form of corporate or municipal bonds, and also preferred stock. Most problematic among those issued were those sold by student loan agencies. ARS are essentially long-term financial instruments that have maturity dates of 30+ years, but which were characterized and marketed as short-term, liquid and cash-like investments given the fact that their interest rates were reset through regular auctions (typically held every 7, 28, or 35 days). ARS were also seen and marketed as safe investments that brought a higher yield than other money market options.

ARS were purchased by individual investors, small companies, and charities, as well as both corporations and institutional investors. It is estimated that roughly half of the ARS market is owned by corporate entities, which were largely using ARS as a means of managing their liquidity and short-term cash needs. A number of ARS buybacks have been announced, however, the buybacks are primarily targeted for individual investors, small companies and charities.

Up until February 13, 2008, large banks had helped the ARS market maintain its characteristic liquidity by filling any gaps in auction bidding to prevent failed auctions and to prop the market. However, as the larger market crisis deepened, these banks refused to act as bidders of last resort as they had done previously, and the market collapsed leaving ARS investors with frozen ARS investments. Investors were no longer able to liquidate their “highly liquid” investments. In some cases, interest rates dropped significantly, and some corporations had to undertake write-downs as they reclassified the investments from short to long term. As the current financial conditions of corporations have worsened and liquidity issues have increased, there has been a heightened sense of these problems associated with investments in ARS.

This article seeks to clarify misconceptions regarding announced buybacks and corporate/institutional investor options when it comes to dealing with the issues associated with ARS. It also outlines possible options for corporations facing their frozen ARS investments – particularly litigation options.

Addressing the ARS market failure

Responses to the ARS market failure differ for individuals and corporations. Corporate responses can be broken down into three main categories: 1) participation in large bank buybacks of ARS, 2) participation in already filed class action law suits, and 3) bringing suit as an individual corporation against relevant entities.

Buybacks

In the later part of 2008, many of the entities involved in ARS sales began offering to repurchase the ARS from their customers. (See **Table A** for entities participating in buyback programs, and details on those programs).

These buybacks are a highly limited option when it comes to corporations and institutional investors. Many of these buybacks are entirely limited to individuals and small companies, and most of these retail customer buybacks have already been completed. Those that are not limited to retail customers can still be limiting for corporations/institutional investors in terms of how much they will be able to sell back, timing, and liquidity.

For example, Wachovia has agreed to repurchase \$9 billion of its ARS. Retail customer and charity buybacks were held between November 10, 2008 and November 30, 2008, but corporate/institutional buybacks are not to be held until June 10, 2009. This not only leaves corporate/institutional investors with the funds that remain when June 2009 buybacks begin, but it also only gives these clients access to the liquidity they may need starting in June 2009. UBS provides another example - the UBS buyback includes \$10.4 billion to institutional customers beginning in June 2010.

Additionally, while some entities are repurchasing the ARS at par, most others are repurchasing at much reduced rates and also have high transaction fees. This means investors will have to exchange value for liquidity.

Litigation

A large number of small investors have filed arbitrations, and many settlements have occurred. Furthermore, numerous regulators have undertaken investigations to analyze the sales practices in the ARS industry. State regulators, the Securities and Exchange Commission (“SEC”), the Financial Regulatory Authority (“FINRA”), and notably the New York Attorney General have all initiated such inquiries, and in many cases have concluded that many of the large banks’ actions were fraudulent. Such remedies, however, (most notably the announced buybacks that were in settlement of the various actions brought by the New York Attorney General) are mainly limited to individual investors and small company investors. Thus, where large investors are beyond the scope of these arbitrations or settlements due to their size or for-profit status, litigation may be an option to consider. Litigation has taken the form of both class actions and individual suits.

Class actions: Numerous class actions have been filed in federal court and under federal securities law against each of the banks which sold ARS. The class members for each class action suit include *all persons and entities* that purchased ARS from each of those banks.

Defendants include: A.G. Edwards (of Wachovia), Ameritrade, Bank of America, Calamos Global Dynamic Income Fund, Citigroup, Deutsche Bank, E*Trade Financial Corp., Goldman Sachs, H&R Block, JPMorgan Chase, Merrill Lynch, Morgan Stanley, Northern Trust, Oppenheimer, Raymond James Financial, RBC, Stifel Financial, Suntrust Banks, UBS, Wachovia, and Wells Fargo. (See **Table B** for details on class action lawsuits).

Individual corporation suits: While all ARS purchasers are already in these above-mentioned class action lawsuits, such suits are not always the solution that is best suited to addressing the current specific needs of corporate and institutional investors. For this reason, some corporations/institutional investors have filed suit based on their individual circumstances. For example, due to write-downs of asset accounts and the need to sell ARS at a loss for liquidity purposes, corporations may have unique damages (for example consequential damages) or other claims that class action lawsuits cannot and do not address. Where other investors may be able to hold their investments for the long-term and thus avoid any loss on their ARS, for corporate and institutional investors, a loss of liquidity can result in lost business growth potential, or an inability to meet basic internal financial needs. Additionally, corporations/institutional investors may find individual suits attractive for the greater degree of control over the litigation process they may allow.

Finally, those corporations and institutional investors that may be considering bringing a cause of action against ARS defendants must also keep statute-of-limitations considerations in mind when deciding whether or not to move forward.

Below are two examples of individual suits filed by corporations and the causes of action they are pursuing to illustrate how such a case might proceed.

Ex. Hutchinson Technology Inc.

Hutchinson Technology Inc. (“Hutchinson”) is a Minnesota technology company employing 4500+ people and working primarily with disk drives and biomeasurement. Hutchinson invested \$31 million in ARS through Citigroup and \$70 million through UBS, believing ARS to be a safe and liquid investment.

Hutchinson has brought suit against both Citigroup and UBS alleging that they knew that ARS were not cash equivalents and knew that there were liquidity issues with ARS, but both entities actively represented and marketed them as otherwise. Hutchinson further alleges that both banks knew of the serious market problems developing around the ARS market, and failed to disclose this information. Finally, Hutchinson alleges that both banks manipulated the ARS market when they themselves propped the market to stave off collapse and then suddenly stopped that market support.

More specifically, both Hutchinson complaints bring suit for numerous different types of violations. Such claims include: violations of the Securities Exchange Act of 1934 (“Exchange Act”); violations of Minnesota securities laws; common law fraud; violations of Minnesota Consumer Protection laws; unlawful trade practices; deceptive trade practices; lack of suitability; breach of contract; unauthorized trading; breach of fiduciary duty; conversion; and negligence.

Hutchinson is seeking damages based on the illiquidity of their major investment. Hutchinson alleges that the lack of liquidity has caused damages where Hutchinson is unable to satisfy various financial obligations which they intended to meet with their “liquid, cash-equivalent” investment in ARS. Hutchinson also alleges that their ARS investments’ lost liquidity has caused financial damages where Hutchinson is unable to meet the variable demand of its industry, and is unable to negotiate the rapid changes in technology associated with its industry. Finally, Hutchinson alleges that it has suffered damages where its ARS investments have taken value markdowns.

Ex. Xethanol Corporation

Xethanol Corporation is an alternative energy company that purchased ARS from Deutsche Bank, and has now brought suit on the losses it suffered when it was forced to sell off its ARS at discount from par value in order to make liquid the ARS funds to which they needed access.

Xenathol alleges a violation of Section 12(a)(1) of the Securities Act of 1933 (the “Securities Act”) because the securities sold by the defendant were not registered pursuant to the Securities Act and did not have a valid exemption from registration. Xenathol further alleges that when Deutsche Bank sold ARS through private placement, Xenathol investors found themselves stuck with an illiquid investment which they could not access in order to meet day-to-day cash requirements. In order to access this cash, Xenathol had to sell its ARS at a loss.

Conclusion

Corporations and institutional investors which own ARS are members of the above-referenced class actions. If the ARS were purchased from UBS, Wachovia, Citigroup or Merrill Lynch those investors may be able participate in the buyback programs occurring in 2009 or 2010. However, given the unique financial concerns of corporations/institutional investors, and given the current economic environment, these large entities may want to pursue individual causes of action. Bringing an individual suit may give these large investors a greater degree of control over the litigation process and may allow them to pursue specific damages and specific claims that better address their individual needs and circumstances. The two cases detailed above provide good examples of situations that are well suited to pursuing individual suits.

Table A – Entities Participating in Buyback Programs

<u>Entity</u>	<u>Repurchase Amount</u>	<u>Application</u>	<u>Timeline</u>
Bank of America	\$4.5 billion	Retail customers up to \$10 million, charities up to \$25 million	October 1, 2008- year end
Wachovia	\$9 billion	1) Retail customers and charities up to \$10 million 2) Other clients	1) November 10, 2008- November 28, 2008 2) June 10, 2009-June 30, 2009
Morgan Stanley	\$4.5 billion	Retail customers and charities up to \$10 million	September 30, 2008 – November 30, 2008
UBS	\$18.6 billion	1) \$8.3 billion to retail customers up to \$1 million 2) \$10.4 billion to <u>Institutional customers</u>	1) October 31, 2008 2) starting in June 2010
Citigroup	\$19.5 billion	1) Retail customers 2) \$12 billion to <u>Institutional Investors</u> with over \$10 million	1) August 7, 2008-November 7, 2008
Credit Suisse	\$550 million	Retail customers and charities up to \$10 million	Up to December 11, 2008
Comerica Bank	\$1.46 billion	Retail and institutional customers	October 1, 2008-December 19, 2008
Merrill Lynch	n/a	1) Retail customers up to \$4 million 2) Other customers	1) October 1, 2008-January 15, 2010 2) January 2 2009-January 15, 2010
Goldman Sachs	\$1 billion	Retail customers and charities up to \$10 million	Ends November 12, 2008
JP Morgan Chase	\$3 billion	Retail customers and charities up to \$10 million	August 14, 2008-December 12, 2008
Fidelity	\$300 million	n/a	n/a
Nuveen	\$325 million	n/a	September 25, 2008-October 1, 2008
Suntrust	\$500 million	Retail customers and charities up to \$10 million	No later than 30 days after settlement approved, completed by 60 days
First Southwest	n/a	Retail customers and charities up to \$10 million	No later than 30 days after settlement approved, completed by 60 days
Washington Mutual	n/a	Retail customers and charities up to \$10 million	No later than 30 days after settlement approved, completed by 60 days

Table B – Auction Rate Securities (“ARS”) Class Action Suits

Defendants	Case	Class	Class Period	Primary Cause of Action	Additional Info
Bank of America	<i>Bondar v. Bank of America</i> Filed on: May 22, 2009 Filed in: N.D. Cal.	Persons who purchased ARS from Bank of America Corp., Banc of America Investment Services, Inc., and Banc of America Securities, LLC.	CLASS PERIOD START: 5/22/2003 CLASS PERIOD END: 2/13/2008	Defendants violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 (“Exchange Act”) by deceiving investors about the investment characteristics of ARS and the auction market in which these securities traded	
Calamos Global Dynamic Income Fund	<i>Miller v. Calamos Global Dynamic Income Fund</i> Filed on: April 21, 2008 Filed in: S.D.N.Y	Persons who acquired the Auction Rate Cumulative Preferred Shares of the Calamos Global Dynamic Income Fund pursuant and/or traceable to a false and misleading registration statement and prospectus incorporated therein	In connection with the September 2007 offering	Defendant violated Section 11 and Section 12(a)(2) of the 1933 Act in strict liability.	
Citigroup	<i>In re Citigroup Auction Rate Securities Litigation</i> Filed on: first filed March 26, 2009; consolidated on August 25, 2008 Filed in: S.D.N.Y	Investors who purchased auction rate securities underwritten and/or sold in auctions managed by defendants Citigroup Inc. (NYSE: C), Citigroup Global Markets, Inc. and Smith Barney (“Citigroup ARS”).	CLASS PERIOD START: 03/26/2003 CLASS PERIOD END: 2/13/2008	Defendants manipulated the market by fostering the illusion that a valid market existed where buyers and sellers came together, with supply and demand in balance, allowing for the successful completion of auctions of Citigroup ARS.	CONSOLIDATED
Deutsche Bank	<i>Kraemer v. Deutsche Bank AG</i> Filed on: March 17, 2008 Filed in: S.D.N.Y.	All persons or entities who purchased and continue to hold auction rate securities offered for sale by defendants	CLASS PERIOD START: 3/17/2003 CLASS PERIOD END: 2/13/2008	Defendants violated Sections 10(b) and 20(a) of the Exchange Act by deceiving investors about the investment characteristics of auction rate securities and the auction market in which these securities traded	
E*Trade Financial	<i>Oughtred v. E*Trade Financial Corp.</i> Filed on: April 2, 2008 Filed in: S.D.N.Y	All persons or entities who purchased and continue to hold auction rate securities	CLASS PERIOD START: 4/2/2003 CLASS PERIOD END: 2/13/2008	Defendants violated Sections 10(b) and 20(a) of the Exchange Act by deceiving investors about the investment characteristics of	

		offered for sale by defendants		auction rate securities and the auction market in which these securities traded	
Goldman Sachs	<i>Milch v. The Goldman Sachs Group, Inc.</i> Filed on: April 15, 2008 Filed in: S.D.N.Y.	All persons or entities who purchased and/or repurchased auction rate securities offered for sale by defendants	CLASS PERIOD START: 3/25/2003 CLASS PERIOD END: 2/13/2008	Goldman Sachs violated Sections 10(b) and 20(a) of the Exchange Act by deceiving investors about the investment characteristics of auction rate securities and the auction market in which these securities traded.	
H&R Block	<i>LaGrave v. H&R Block</i> Filed on: September 24, 2008 Filed in: S.D. Ill.	All persons or entities who purchased and continue to hold ARS offered for sale by defendants	CLASS PERIOD START: 8/26/2003 CLASS PERIOD END: 2/13/2008	Defendants misrepresented the liquidity of the auction-rate securities it sold	
JPMorgan Chase	<i>Silverman v. JPMorgan Chase & Co.</i> Filed on: March 31, 2008 Filed in: S.D.N.Y	Persons who purchased Auction Rate Securities from JP Morgan Chase & Co. and J.P. Morgan Securities, Inc.	CLASS PERIOD START: 3/31/2003 CLASS PERIOD END: 2/13/2008	JPMorgan violated Sections 10(b) and 20(a) of the Exchange Act by deceiving investors about the investment characteristics of auction rate securities and the auction market in which these securities traded.	on April 18, 2008, the case was dismissed without prejudice as to JP Morgan Chase & Co.; J.P. Morgan Securities, Inc. CONSOLIDATED
Merrill Lynch	<i>Burton v. Merrill Lynch & Co., Inc.</i> Filed on: March 25, 2008 Filed in: S.D.N.Y	All persons or entities who purchased and continue to hold auction rate securities offered for sale by defendants	CLASS PERIOD START: 03/25/2003 CLASS PERIOD END: 02/13/2008	Merrill Lynch violated Sections 10(b) and 20(a) of the Exchange Act by deceiving investors about the investment characteristics of auction rate securities and the auction market in which these securities traded	CONSOLIDATED
Morgan Stanley	<i>Miller v. Morgan Stanley</i> Filed on: March 31, 2008 Filed in: S.D.N.Y	Thousands of investors who acquired auction-rate securities from Morgan Stanley	CLASS PERIOD START: 3/25/2003 CLASS PERIOD END: 2/13/2008	Morgan Stanley "deceptively marketed" auction-rate securities as cash alternatives to money-market funds for investors needing liquidity and failed to make material disclosures about those securities. The complaint is seeking injunctive relief to "compel Morgan Stanley to rescind millions of dollars in ARS	CONSOLIDATED

				transactions" and is seeking compensatory and punitive damages	
Northern Trust	<i>Aimis Art Corp. v. Northern Trust Corp.</i> Filed on: September 17, 2008 Filed in: S.D.N.Y	All persons or entities which purchased auction rate securities) from Northern Trust	CLASS PERIOD START: 09/16/2003 CLASS PERIOD END: 02/13/2008	Northern Trust materially misrepresented the liquidity of and risks associated with auction rate securities and omitted material facts about the auction rate securities market	
Oppenheimer	<i>Grossman v. Oppenheimer & Co. Inc.</i> Filed on: April 11, 2008 Filed in: S.D.N.Y	All persons or entities who purchased and/or acquired ARS offered for sale by Oppenheimer Holdings Inc., Oppenheimer & Co. Inc, Oppenheimer Asset Management and Freedom Investments Inc. ("Oppenheimer"),	CLASS PERIOD START: 4/9/2003 CLASS PERIOD END: 2/13/2008	Oppenheimer violated Sections 10(b) and 20(a) of the Exchange Act by deceiving investors about the investment characteristics of Auction Rate Securities and the auction market in which these securities traded	CONSOLIDATED
Raymond James Financial	<i>Defer LP v. Raymond James Financial, Inc.</i> Filed on: April 8, 2008 Filed in: S.D.N.Y	behalf of all persons or entities who purchased and continue to hold auction rate securities offered for sale by defendants	CLASS PERIOD START: 4/8/2003 CLASS PERIOD END: 2/13/2008	Raymond James violated Sections 10(b) and 20(a) of the Exchange Act by deceiving investors about the investment characteristics of auction rate securities and the auction market in which these securities traded	
RBC	<i>Brigham v. Royal Bank of Canada</i> Filed on: May 12, 2008 Filed in: S.D.N.Y	Persons who purchased Auction Rate Securities from RBC Dain Rauscher Inc., Royal Bank of Canada, and RBC Capital Markets Corporation and who continued to hold such securities as of February 13, 2008.	CLASS PERIOD START: 5/12/2003 CLASS PERIOD END: 2/13/2008	RBC Dain Rauscher violated Sections 10(b) and 20(a) of the Exchange Act by deceiving investors about the investment characteristics of auction rate securities and the auction market in which these securities traded	
Stifel Financial	<i>Merrick v. Stifel Financial Corp.</i> Filed on: August 8, 2008 Filed in: E.D. Missouri	All persons or entities who purchased and continue to hold auction rate securities ("ARS") offered for	CLASS PERIOD START: 06/11/2003 CLASS PERIOD END: 02/13/2008	Stifel Financial Corp. and its subsidiary Stifel, Nicolaus & Company, Inc. violated Sections 10(b) and 20(a) of the Exchange Act by deceiving investors about	

		sale by Defendants		the investment characteristics of ARS and the auction market in which the securities are traded	
Suntrust Banks	<i>Zisholtz v. Suntrust Banks, Inc.</i> Filed on: April 02, 2008 Filed in: N.D. Ga.	Persons who purchased and/or repurchased ARS from Defendants	CLASS PERIOD START: 04/01/2003 CLASS PERIOD END: 02/13/2008	SunTrust violated the securities laws by deceiving investors about the investment characteristics of ARS and the auction market in which these securities traded	
TD Ameritrade	<i>Humphrys v. TD Ameritrade Holding Corp.</i> Filed on: March 19, 2008 Filed in: S.D.N.Y	Persons who purchased ARS from TD Ameritrade Holding Corporation and TD Ameritrade, Inc., who continued to hold such securities as of February 13, 2008.	CLASS PERIOD START: 3/19/2003 CLASS PERIOD END: 2/13/2008	TD Ameritrade violated Sections 10(b) and 20(a) of the Exchange Act by deceiving investors about the investment characteristics of auction rate securities and the auction market in which these securities traded	CONSOLIDATED
UBS	<i>Chandler v. UBS AG</i> Filed on: March 21, 2008 Filed in: S.D.N.Y	Persons who purchased ARS from UBS, UBS Securities and UBS Financial Services during the Class Period and who continued to hold such securities as of February 13, 2008	CLASS PERIOD START: 3/21/2003 CLASS PERIOD END: 2/13/2008	UBS violated Sections 10(b) and 20(a) of the Exchange Act by deceiving investors about the investment characteristics of auction rate securities and the auction market in which these securities traded	CONSOLIDATED
Wachovia	<i>Waldman v. Wachovia Corp.</i> Filed on: March 19, 2008 Filed in: S.D.N.Y	Persons who purchased ARS from Wachovia Corporation and Wachovia Securities, LLC, during the Class Period and who continued to hold such securities as of February 13, 2008	CLASS PERIOD START: 3/19/2003 CLASS PERIOD END: 2/13/2008	Wachovia violated Sections 10(b) and 20(a) of the Exchange Act by deceiving investors about the investment characteristics of auction rate securities and the auction market in which these securities traded	
Wells Fargo	<i>VanDyke v. Wells Fargo & Co.</i> Filed on: April 14, 2008 Filed in: N.D. Cal.	All persons or entities who purchased and continue to hold ARS offered for sale by defendants	CLASS PERIOD START: 4/14/2003 CLASS PERIOD END: 2/13/2008	Wells Fargo violated Sections 10(b) and 20(a) of the Exchange Act by deceiving investors about the investment characteristics of auction rate securities and the auction market in which these securities traded	CONSOLIDATED