HGT LAW

Client Newsletter

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Auction Rate Securities Update: Second Circuit Decision In *Wilson v. Merrill Lynch & Co., Inc.*

On November 14, 2011, the Court of Appeals for the Second Circuit issued an opinion in Wilson v. Merrill Lynch & Co., Inc., 2011 WL 5515958 (2d. Cir. 2011), dismissing an appeal brought by a class of purchasers of all auction rate securities ("ARS") for which Merrill Lynch served as sole, lead, co-lead or joint lead auction dealer between March 25, 2003 and February 13, 2008. The class alleged that Merrill Lynch had engaged in a scheme to manipulate the ARS market, in contravention of Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5(a) & (c) promulgated thereunder. The decision in Wilson provides greater clarity going forward as to the types of ARS claims that will be allowed to proceed, and claims that will be dismissed.

The ARS Marketed By Merrill Lynch in *Wilson*

ARS are debt or equity interests issued by various public and private entities in which the rate of interest to be paid on the securities is set by auction. At each auction, participants submit orders to buy, sell, or hold ARS at particular interest rates or in particular quantities. When the number of shares subject to buy orders at a given rate meets or exceeds the number of shares offered for sale at that rate, the auction clears, with the "clearing rate" set at the lowest interest rate at which all sell orders can be fulfilled. However, when the number of shares offered for sale exceeds the number of shares bid for purchase, the auction fails, and the interest rate on the ARS is reset to a predetermined rate known as the "maximum rate", a type of penalty rate. If sufficiently high, the maximum rate ensures that the ARS remain liquid by attracting new buyers or by prompting the issuer of the ARS to refinance and redeem the ARS.

In *Wilson*, the lead plaintiff purchased $125,000 of ARS for which Merrill served as dealer. The lead plaintiff made his purchases in July 2007, before the market for ARS began to experience difficulties. Central to his and the class's market manipulation claims against Merrill Lynch was the allegation that, between January 3, 2006 and May 27, 2008, Merrill placed support bids in more than 5,800 ARS auctions, which would otherwise have failed. The class alleged that, by failing to disclose this inherent lack of liquidity to purchasers, Merrill Lynch created a false impression as to the level of demand and liquidity, as well as the likelihood of auction failures.

Merrill Lynch countered that, as a result of a settlement reached with the SEC in May 2006, Merrill was required to, and did in fact, provide greater disclosures as to its ARS practices. Specifically, Merrill Lynch posted on its website a document which described its ARS practices and procedures and disclosed that: "Merrill Lynch is permitted, but not obligated, to submit orders in auctions for its own account either as a bidder or a seller, or both, and routinely does so in its sole discretion" and "Merrill Lynch may routinely place one or more bids in an auction for its own account to acquire auction rate securities for its inventory, to prevent an auction failure ... or an auction from clearing at a rate that Merrill Lynch believes does not reflect the market for the securities."

Based on these disclosures, the Second Circuit affirmed the decision of the lower court (Preska, C.J.) dismissing the claims for market manipulation. Noting that market activity must involve misrepresentation or nondisclosure in order to be manipulative, the Second Circuit held that Merrill Lynch's disclosures of its support bid practices negated a claim for market manipulation. Amongst other reasons, the Second Circuit held that Merrill Lynch's disclosures made investors aware not only of the *possibility* that Merrill would place support bids in some auctions that it managed and the *possibility* that in the absence of these bids, some of these auctions might fail, but also the *extent* of Merrill Lynch's interventions. The Second Circuit reasoned that Merrill Lynch's disclosure that it "may routinely" place support bids constituted sufficient disclosure to investors that Merrill Lynch might even place support bids in *every* Merrill ARS auction that took place over a particular period.

The upshot of the Second Circuit's decision is that, without more, ARS claims under Section 10(b) of the Exchange Act (whether for market manipulation, as in *Wilson*, or for misrepresentation and omission) will likely fail in circumstances where the defendant who marketed the ARS provided disclosures detailing its practices of submitting support bids.

Claims Are Still Viable With Respect To ARS Purchased After The Market For ARS Had Already Begun To Fail

The fact that an investment bank or broker disclosed its practice of placing support bids will not, however, always immunize that bank or broker from liability. One specific situation where ARS claims will still likely succeed is where, even after the ARS markets had begun to experience stresses in August 2007, investment banks continued to market ARS to investors by assuring the investors that nothing was wrong with the ARS markets, even though the banks knew internally that this was untrue. An investor who relied on these assurances from the investment bank and purchased ARS will have viable claims – as recognized in several federal district court decisions, and now the Second Circuit itself in *Wilson*.

For example, in *Defer LP v. Raymond James Financial, Inc.,* No. 08 Civ. 3449(LAK), 2010 WL 3452387 (S.D.N.Y. September 2, 2010), the plaintiffs, a class comprising all persons and entities who purchased ARS from Raymond James during the class period, brought claims for violations of Section 10(b) of the Exchange Act and Rule 10b–5. Based on the facts alleged, Judge Kaplan upheld the plaintiffs' claims against Raymond James with respect to misstatements and omissions that were made by Raymond James in the period November 2007 through February 2008. That was because, as alleged by the plaintiffs, by November 2007, the ARS market was liquid due, in large part, to the sustained and systematic intervention of auction brokers. Under these circumstances, Raymond James' financial advisors engaged in misleading conduct by failing to disclose the interventions and the illiquidity, and by continuing to market the ARS to investors as the equivalent of cash. Further, the court held, it was reasonable to infer that Raymond James had a motive to conceal the increasing risk of ARS illiquidity from customers based on the allegation that,from November 2007 forward, Raymond James sought to offload its growing inventory of ARS.

Similarly, in *Dow Corning Corp. v. Merrill Lynch &*

Co., Inc., No. 09 MD 2030(LAP), 2011 WL 1330847 (March 30, 2011), Judge Preska upheld Section 10(b) claims brought by plaintiffs Dow Corning Corporation, Hemlock Semiconductor Corporation, and Devonshire Underwriters Limited, against Merrill Lynch. The plaintiffs alleged that, commencing in August 2007, when ARS markets started to seize up, the plaintiffs asked Merrill Lynch on several occasions why ARS interest rates were increasing, and sought other assurances that there were no problems with liquidity in the ARS market generally. The plaintiffs alleged that Merrill Lynch falsely assured the plaintiffs of the safety of their ARS investments, even though Merrill Lynch had begun internally discussing the possibility of withdrawing their support bids for Merrill Lynch-brokered ARS due to weak market demand, and even though Merrill Lynch knew of the failure of more than one ARS auction up to that point.

Based on these facts, Judge Preska distinguished her own decisions in other cases in which she dismissed claims against Merrill Lynch based on the fact that Merrill Lynch had disclosed its support bid practices on its website after the settlement with the SEC in 2006. According to Judge Preska, "Unlike other ARS cases in this multidistrict litigation, this case involves allegations that Defendants made specific misrepresentations to reassure Plaintiffs about ARS after the ARS market began to crumble. … To be sure, as in other cases, Plaintiffs were made aware of the general risks involved in ARS investments and the ability of Defendants to place (or not place) support bids. But this case involves alleged misstatements made in response to specific inquiries about ARS liquidity after Plaintiffs had observed signals that market conditions had changed and when Defendants allegedly had specific information that liquidity risks had increased. This case does not involve challenges to Defendants' public disclosures or ARS practices more generally."

Now, in *Wilson*, the Second Circuit has affirmed the vitality of the above decisions in *Raymond James and in Dow Corning.* In denying the appeal by the plaintiffs in *Wilson*, the Second Circuit specifically noted the limited nature of its holding: "We emphasize the limited nature of our holding today. We conclude only that Merrill's particular disclosures sufficiently alerted investors in Merrill ARS of the likelihood that the interest rates and apparent liquidity of these ARS reflected Merrill's own interventions in these auctions rather than the 'natural interplay of supply and demand.' … Our holding rests in substantial part on the fact that ***Wilson's purchase of his securities antedated the time that Merrill was alleged to have learned that the ARS market was no longer viable and to have made statements directed at investors that were at odds with its internal understanding of the liquidity of these securities."*** (emphasis added). In other words, if the plaintiff in *Wilson* had acquired his securities after the ARS markets started to fail, and after Merrill Lynch learned of facts that it failed to disclose to investors (as was alleged in *Dow Corning*), the result would have been different. For emphasis, the Second Circuit noted that "Nor do we hold that website disclosures like those here may categorically immunize ARS dealers from claims that their bidding practices were manipulative, regardless of what the dealer knew and communicated to investors about its bidding practices and the securities' liquidity."

For more information on auction rate securities and any of the decisions discussed above, or if you hold auction rate securities and would like to discuss your potential claims, please contact us (info@hgtlaw.com) to arrange a free consultation.