ALERTS AND UPDATES

Circuit Courts Uphold Dismissal of Securities Claims Based on Alleged Fraud in Sale of Auction Rate Securities

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Two recent opinions from separate federal courts of appeal upheld the dismissal of lawsuits by sophisticated investors that suffered losses in the auction rate securities ("ARS") market against the securities broker-dealers that allegedly fraudulently induced the purchase of the ARS.[1]

The plaintiffs in the two separate lawsuits were identical: Ashland, Inc., a diversified global chemical company, and AshThree LLC, the special purpose entity that the company solely owned and operated (collectively, the "Company"). The Company contended that the securities broker-dealers had assured it that the ARS were safe, liquid instruments suitable to the Company's conservative investment policies.[2] Furthermore, the Company maintained that not only did the securities broker-dealers represent that auction failures were very rare, but also that, should the need arise, the broker-dealers would act to prevent auction failures by placing sufficient proprietary bids. When the ARS market collapsed in February 2008, the Company was left with millions of dollars in illiquid ARS and, unable to sell most of these holdings, discounted them by millions of dollars and lost similar amounts in the few sales it did execute.

I. The Second Circuit Holds That "Sophisticated Investors" Cannot Plead Reasonable Reliance on Alleged Misrepresentations Contradicted by the Securities Broker-Dealer's Publicly Filed Disclosure Statements.

To sustain a claim for securities fraud under section 10(b) of the Securities Exchange Act, a plaintiff needs to prove, among other things, that it reasonably relied upon the broker-dealer's alleged ARS misrepresentations. According to the Second Circuit in *Ashland, Inc. v. Morgan Stanley & Co.*, "An investor may not justifiably rely on a misrepresentation if, through minimal diligence, the investor should have discovered the truth."[3] Among other factors relevant to this "minimal diligence" analysis are the investor’s sophistication and expertise in financial and securities matters, and whether the investor had access to the relevant information. (Slip op. at 9).

The Second Circuit held that the Company, which admitted to being a "sophisticated investor," could not have reasonably relied on the alleged misrepresentations, which were contradicted by the broker-dealer's publicly available statements. Those SEC-mandated statements disclosed the very liquidity risks about which the Company claimed to have been misled. For example, the Company could not have reasonably relied on any representation that the broker-dealer would intervene to prevent auctions from failing, because the broker-dealer's publicly filed statement disclosed that the broker-dealer would intervene only at its discretion and was not obligated to bid in any auction to prevent an auction from failing.

An admitted sophisticated investor is responsible for conducting its own minimal due diligence to "apprise itself of the publicly disclosed riskiness of ARS as liquid investments." (Slip op. at 13). Even though there was some issue about precisely when the Company received its own copy of the SEC-mandated disclosure statement from the broker-dealer, the Second Circuit noted that the statement was nevertheless publicly available online and could have been "easily discovered" through minimal diligence. (Slip op. at 10 n. 4).

II. The Sixth Circuit Requires an Allegedly Defrauded ARS Investor to Explain with Sufficient Facts "Why or How" the Securities Broker-Dealer Knew About the ARS Market's Impending Illiquidity.

In its opinion affirming the dismissal of the Company's complaint against a separate broker-dealer, the Sixth Circuit in *Ashland, Inc. v. Oppenheimer & Co.* focused not on the reasonableness of the Company's reliance on the alleged misrepresentations, but on whether the Company had satisfactorily pleaded scienter. That is, the Company needed to have stated sufficient facts on which it formed its belief that the broker-dealer actually knew about the alleged liquidity problems in the ARS market.[4]

The Company's central contention was that the broker-dealer peddled ARS as liquid, short-term investments, all while withholding a key factor about the market—that the market's continued health depended on the intervention of underwriters, many of whom were abandoning ARS auctions. However, the Sixth Circuit held that the Company did not explain with sufficient facts "why or how" the securities broker-dealer knew about the ARS market's impending illiquidity.

The Sixth Circuit found that the Company failed to state any facts explaining why or how the broker-dealer possessed advance, non-public knowledge that underwriters would jointly exit the ARS market and cause its collapse in February 2008. Nor did the Company argue that the hazard facing the ARS market was one of which any reasonable person would have known. At best, according to the circuit court, the alleged facts suggested that perhaps a few broker-dealer employees were aware of what might happen if the underwriters left the ARS market—a seemingly remote risk, given the market's past stability. As the Sixth Circuit held, the more-compelling explanation was that the near-spontaneous collapse of the ARS market caught the broker-dealer and its employees off-guard.

Moreover, the Sixth Circuit concluded that dismissal was consistent with how other courts were resolving ARS-related litigation against investment banks and broker-dealers. In the fraudulent-misrepresentation cases that survived motions to dismiss, those plaintiffs sufficiently explained why or how those defendants knew about the ARS market's impending illiquidity. On the other hand, lawsuits have been dismissed where the plaintiff-investor offered only vague and unsubstantiated allegations that market participants knew of, yet failed to disclose, risks surrounding the ARS market.[5]

For Further Information

If you have any questions about this *Alert*, please contact Wayne A. Mack, Matthew M. Ryan, any member of the Securities Litigation Practice Group or the attorney in the firm with whom you are regularly in contact.

Notes

1. *Ashland, Inc. v. Morgan Stanley & Co.*, No. 10-1549 (2d Cir. July 28, 2011); *Ashland, Inc. v. Oppenheimer & Co.*, No. 10-5305 (6th Cir. July 28, 2011).
2. Auction rate securities (or ARS) are long-term bonds and stocks whose interest rates or dividend yields are periodically reset through auction. At each auction, holders and buyers of the securities specify the minimum interest rate at which they want to hold or buy. If buy/hold orders meet or exceed sell orders, the auction succeeds. If supply exceeds demand, the auction fails and the issuer is forced to pay a higher rate of interest in order to penalize it and to increase investor demand. Though they have no obligation to do so, ARS underwriters (generally investment banks) may partake in the auctions, placing proprietary bids, to help ensure that the auctions do not fail. The ARS at issue in these matters were backed by student loan obligations ("SLARS").
3. *Ashland, Inc. v. Morgan Stanley & Co.*, slip op. at 9, quoting *Brown v. E.F. Hutton Group., Inc.*, 991 F.2d 1020, 1032 (2d Cir. 1993).
4. In the securities fraud context, under the Private Securities Litigation Reform Act of 1995 ("PSLRA"), a plaintiff "shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1).
5. *Ashland, Inc. v. Oppenheimer & Co.*, slip op. at 10.