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Billions Not for the Plaintiffs Bar

Auction-rate securities deals don't presage windfall for lawyers.

By Michael J. Rivera and Erik N. Frias

Major brokerage firms are agreeing to buy back billions of dollars of outstanding auction-rate securities—a welcome surprise for investors, whose assets lost liquidity overnight when the market for the securities collapsed in February.

The giant buyback agreements represent a novel approach to resolving regulatory investigations. But equally, if not more, interesting is the profound impact they will likely have on the considerable private litigation begun in the past six months.

Although the plaintiffs bar has viewed the downfall of the auction-rate market as a boon for their business, that now seems unrealistic. The recent agreements may effectively shut down pending and future private litigation on behalf of auction securities investors.

Failing Auctions

Auction-rate securities have been sold since the early 1980s, initially focusing on institutional investors. In later years, more individual investors entered the market. Many saw these securities as highly liquid investments that offered better returns than money-market funds. Low transaction costs also made auction-rate securities an attractive form of financing for many different types of issuers, including municipalities, closed-end investment funds, and student loan authorities. By February 2008, the market had grown to $330 billion.

Although auction-rate securities vary in form and structure, they share an important defining characteristic: After their initial distribution, they are sold at par value at periodic auctions used to reset their interest or dividend rate. As a result, investors have tended to enter and exit the market at regular intervals, while receiving yields adjusted to reflect current market rates.

Historically, brokerage firms serving as auction dealers entered their own bids in auctions, dubbed "support bids." Support bids are designed to ensure that auctions clear at a market rate and, if necessary, prevent auction failures, which occur when more investors bid to sell than to buy or hold.

Until recently, the auction-rate securities market operated with remarkable efficiency, and auction failure was extraordinarily rare. Anecdotal evidence suggests that, until the current disruption, no more than 100 auctions failed over the market's 20-year history—an infinitesimal number given that the market had developed to a point where several hundred auctions were conducted daily.

That statistic changed drastically when fear rippled through the credit markets in late 2007 and rating agencies began to downgrade certain bond insurers that backed auction-rate securities.

In response, investors began to flee the market, requiring dealers to commit an increasing and ultimately unsustainable amount of capital to prevent auction failures. Dealers ceased submitting support bids, thereby opening the dam for a flood of auction failures. Although some liquidity has returned for certain types of products since the February collapse, the vast majority of auctions continue to fail, and little hope exists for the market to rebound.

Buybacks

This kind of collapse is rarely overlooked by regulators and inevitably triggers investigations.

Within the last two weeks, several major brokerage firms that serve as auction dealers have agreed to repurchase auction securities from their customers. The U.S. Securities and Exchange Commission, the New York state attorney general, and other regulators announced settlements with UBS and Citigroup in which those firms agreed to commit a combined $18.5 billion to repurchase the auction securities

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held by their retail and small institutional clients. Morgan Stanley and J.P. Morgan have entered into similar settlements as well, committing a combined $7 billion to repurchase their customers' auction securities. The settlements contemplate that larger institutional customers will receive refunds as well, although with lower priority.

Regulators have indicated that investigations of other auction dealers continue, and it is widely expected that more settlements will be reached, likely with terms similar to the agreements already known. Meanwhile, Merrill Lynch has announced its own repurchase program and committed more than $11 billion to fund it.

What exactly are the brokerage firms alleged to have done wrong? The facts underlying each settlement have not yet been made public, and the alleged misconduct is likely to vary from firm to firm. Regulators reportedly have been examining whether sales personnel at these firms touted auction-rate securities as highly liquid investments of the same quality as money-market funds or other cash equivalents.

Other issues raised by regulators have included whether undue influence was exerted over the content of research reports analyzing auction securities, whether employees (including senior executives) and select customers sold their holdings before the market collapsed with knowledge of a firm's imminent withdrawal of support, and whether firms failed to adequately disclose the full extent to which their support bidding had prevented auction failures.

Made Whole

Obviously such regulatory attention is serious, and the companies involved are paying out real money. Under normal circumstances, this would cause great excitement in the plaintiffs bar, but that is not likely in this case.

The reason: The losses of individual investors who might be plaintiffs will now be fully compensated, leaving little to no damages to pursue in court.

Under the reported terms of the settlements, the auction dealers will repurchase all outstanding holdings of auction-rate securities currently held by their retail and small institutional customers at par value—that is, the price at which the customers bought them. Moreover, any such customers who sold their auction-rate holdings below par value after the market collapse will also be compensated for their loss.

These buybacks and reimbursements will probably cover the most common form of loss. Generally, these securities, even after they lost liquidity, never stopped paying interest or dividends (though the terms of some call for the payment of reduced rates upon auction failure).

Plus, there's still more compensation available for customers who can prove that they suffered losses as a consequence of their inability to sell their auction-rate securities. Such customers can seek damages under a special arbitration procedure being established under the oversight of the Financial Industry Regulatory Authority.

These consequential damages will apparently cover personal costs resulting from the lack of liquidity. Cited examples include a mother who had set money aside in auction-rate securities to pay for a daughter's wedding. Institutional investors, of course, are unlikely to have suffered these sorts of personal damages.

In these arbitration proceedings, the brokerage firms have agreed not to contest liability for their alleged misrepresentations about auction-rate securities. Thus, the special arbitration proceedings will likely turn out to be little more than a forum for proving the amount of collateral damages.

Bottom line: Individual investors typically continued to receive interest and dividends. They will get their invested money back. And they will be compensated for consequential damages. Fundamentally, they will be made whole without assistance from the courts.

Getting Together?

The most interesting legal aspect of these settlements and buyback programs may be their debilitating impact on the numerous class actions and other private suits filed since the market seized up.

Most problematic for any private suit, including putative class actions, is the inability to prove damages—a central element of any private action. If all auction dealers ultimately agree to implement their own buyback programs for customers, then all those potential plaintiffs will have no remaining damages.

Moreover, it will be difficult for plaintiffs attorneys to obtain class-action status on behalf of this population of potential plaintiffs.

Even without these settlements, class certification would have been an uphill battle because it requires establishing a commonality among all the plaintiffs' claims that predominates over their individual issues. But private auction-rate claims seem to be rooted in representations made by hundreds of individual brokers, which likely varied widely. (One exception might be if the brokers relied on some kind of systematic device, such as a telephone script touting these products as cash equivalents.)

Investors who suffered consequential damages should similarly have difficulty establishing a class because those damages are certain to lack commonality. Thus, most pending lawsuits, especially putative class actions, are at risk of being dismissed.

It is a truly unusual circumstance that businesses pay billions of dollars to settle fraud investigations by regulators with little available opportunity for the plaintiffs bar to profit. Yet government and industry have worked cooperatively to craft a solution to the auction-rate securities problem in such a way that private litigation will be largely unnecessary and unavailable. That's rare, but it seems to be exactly what's going to happen here.

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