

Pleading of Scienter Issues in Auction Rate Securities Litigation



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Along with "sub-prime mortgages," "credit default swaps" and "Bernie Madoff," the phrase "auction rate securities" has become part of the lore surrounding the current economic crises. The common denominator among these is their seeming causal relationship with massive investor losses and, as sure as night follows day, when a group of investors suffers significant losses, securities litigation is sure to follow.



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To some extent, however, the impetus for private civil litigation with respect to auction rate securities (ARS) was diminished by aggressive, coordinated and reasonably prompt efforts by the SEC Division of Enforcement, FINRA, the New York Attorney General's Office and the North American Securities Administrators Association to obtain settlements—with many of the largest participants in the ARS market—structured to restore liquidity to investors.

Nonetheless, securities actions were commenced against many participants in the ARS market. Thus far, for the most part, these actions have been unsuccessful. The most recent decision in an ARS case, *Defer LP v. Raymond James Financial Inc.*, No. 08-Civ. 3449(LAK) (SDNY Sept. 2, 2010), in which Judge Lewis A. Kaplan granted defendants' motion to dismiss with respect to all but one aspect of the claims asserted by the putative plaintiff class, exemplifies the difficulties inherent in the prosecution of claims based on purchases of ARS.

Although only first developed in 1984, by early 2008 there were more than \$330 billion of ARS in the market, nearly a 25 percent increase over the \$265 billion of such securities in the market at the end of 2005. As Judge Kaplan explained in the *Defer* decision, auction rate securities were attractive to issuers, which could obtain long-term financing at less expensive, short-term interest rates, and to investors, who could earn a better return on investments that were marketed as being "nearly as liquid" as cash. The complaint alleged that, until August 2007, dealers in ARS placed support bids to ensure the success of the auctions, which provided the touted liquidity. At that time, some dealers stopped that practice and some auction failures ensued. In February 2008, when all major auction dealers, including defendants in *Defer*, stopped intervening with support bids, 87 percent of the auctions failed and more than \$300 billion of ARS became illiquid.

Defendant Raymond James & Associates Inc. (RJA) underwrote offerings of ARS, managed ARS auctions and, through its financial advisors, sold ARS to the members of the putative class. Defendant Raymond James Financial Services Inc. (RJFS) also sold ARS to putative class members through its financial advisors. RJA and RJFS are sister subsidiaries of defendant Raymond James Financial Inc. (RJF). Plaintiffs alleged that RJA and RJFS violated §10(b) and Rule 10b-5 and that RJF and RJA were controlling persons liable under §20(a).

The essence of plaintiffs' claims was that RJA and RJFS represented to their respective financial advisors (and through them to the members of the putative class) that ARS were cash equivalents and highly liquid when, in fact, the liquidity was a façade and wholly dependent on auction dealer intervention. It was also alleged that RJA and RJFS failed to disclose other risk characteristics of ARS, including their long maturity periods, their lack of features designed to ensure a holder's ability to sell, their being subject, in some cases, to interest rate caps that would reset interest rate levels to below-market rates, their being traded in an illiquid market supported by manipulation and dependent on dealer intervention, that they required active investor participation to earn the highest returns, and that they would be salable only at substantial discounts if the auctions failed. Plaintiffs alleged that RJA and RJFS were aware of these risks, but made no disclosures to investors about the true nature of ARS, including the risks of illiquidity and auction failure, until certain disclosures were made in trade confirmations in January 2007 and then on a public Web site in August 2007.

Pleading Scienter

The main point of contention between the parties on defendants' motion to dismiss plaintiffs' claims under §10(b) of the Exchange Act and Rule 10b-5 was whether the complaint sufficiently alleged that defendants, in

connection with the purchase or sale of ARS, made materially false statements or omitted material facts with scienter. Addressing the scienter pleading requirement, Judge Kaplan applied the standards imposed by the Private Securities Litigation Reform Act, which requires that plaintiffs state with particularity facts giving rise to a "strong inference" that the defendant acted with the requisite state of mind, identified as an "intent to deceive, manipulate, or defraud."

An inference of scienter is ordinarily pled by alleging facts showing that (1) defendants had both "motive and opportunity" to commit the fraud, or (2) facts constituting convincing circumstantial evidence of "conscience behavior." Under the applicable standard, an alleged inference of scienter is considered strong enough "only if a reasonable person would deem [it] cogent and at least as compelling as any opposing inference one could draw from the facts alleged."¹

The Scienter of RJA

Under a "motive and opportunity" theory, plaintiffs claimed that RJA had been motivated to commit the alleged fraud in order to "unload" its inventory of ARS and thereby reduce its exposure to losses on illiquid ARS. This theory was based on allegations that RJA employees had sent e-mails, beginning in November 2007, to its financial advisors indicating that RJA had a large ARS inventory which it needed to sell to comply with its internal risk limits.

Noting that "a motive must antedate the alleged fraud," Judge Kaplan reasoned that any alleged motivation RJA had to unload its inventory could not be applicable to the period between April 2003, when plaintiffs alleged the fraud began, and November 2007 when, it was alleged, RJA actually came to the conclusion that its ARS inventory should be sold. Thus, Judge Kaplan found motive to be sufficiently alleged only from November 2007 to the end of the alleged class period in February 2008.

Judge Kaplan also found that plaintiffs failed to plead scienter for the earlier period under a "conscious misbehavior or recklessness" theory, which required that the complaint allege that RJA knew facts or had access to specific information—or "red flags"—contradicting its allegedly false and misleading statements or imposing a duty to investigate further. Although plaintiffs asserted that RJA knew or had been reckless in not knowing that the ARS market was liquid only because of auction dealer intervention, and alleged specifically that an SEC cease and desist order in May 2006 had directed certain auction dealers (but not RJA) to end "undisclosed manipulative practices" with respect to auction rate securities, Judge Kaplan held that these allegations failed to state, with requisite particularity, how the SEC order constituted a "red flag" which would have alerted RJA to the fact that dealer intervention was the only thing keeping the entire market liquid. Judge Kaplan pointed to the failure to allege the nature of the practices alleged in the SEC complaint, the extent of those practices in the ARS market, whether those practices affected any of the ARS sold by RJA, and if and when RJA became aware of the SEC order.

Plaintiffs' other reasons for inferring that RJA had knowledge that other auction dealers systematically propped up the ARS market, were also rejected. First, plaintiffs maintained that RJA was an ARS underwriter and dealer and therefore had an obligation to know that the market functioned only as a result of systematic auction dealer intervention. Judge Kaplan held, however, that even if RJA had a duty to make some type of investigation into the market, such "vague and general propositions" did not rationally suggest that RJA knew of or had access to the particular fact that the entire market was liquid only because of the auction dealer's systematic intervention.

Plaintiffs were also faulted for failing to allege any specific facts to support the assertion that RJA would have discovered the market's dependence on such intervention had it made a more searching inquiry. Finally, Judge Kaplan rejected plaintiffs' arguments that scienter could be inferred either from RJA's selective and incomplete disclosure to investors or from allegations that RJA deliberately withheld material information about ARS from financial advisors. These arguments were viewed as simply presupposing that RJA knew the extent to which market liquidity depended upon auction dealer intervention, which the complaint had failed to allege with the requisite particularity.

Imputation of Scienter

Addressing the claims against RJFS, Judge Kaplan rejected the notion that RJA's scienter could be attributed to RJFS simply because RJFS was an affiliate of RJA or because RJFS was RJA's agent. Plaintiffs sought to impute RJA's scienter to RJFS, citing *In re Marsh & McLennan Cos. Inc. Sec. Litig.*, in which the court imputed a subsidiary's scienter to its corporate parent based on allegations that the parent knew about the subsidiary's intentional misconduct.²

Judge Kaplan distinguished the facts in *Marsb* from the allegations in *Defer*, explaining that any allegations that RJA provided RJFS with unspecified information about ARS said nothing about whether RJA had conveyed everything it knew to RJFS, or had instead simply misled RJFS. The court found that plaintiffs provided no support for the proposition that scienter could be attributed to an agent, citing the principle that "an agent generally is not liable for the acts of co-agents or, for that matter, any other person or entity that the agent does not control."³ The §10 and Rule 10b-5 claims against RJFS were therefore dismissed for failure to plead scienter that was directly attributable to RJFS.

Implications for Fraud Claims

Ultimately, the only legally sufficient claim of a primary violation of the Exchange Act and Rule 10b-5 recognized by the court was plaintiffs' claim against RJA based on certain statements made by an RJA financial advisor.⁴ With respect to these statements, plaintiffs' allegations had to meet the additional standard of materiality requiring a "substantial likelihood that disclosure of the omitted fact would have been viewed by a reasonable investor as having significantly altered the 'total mix' of information available."⁵

The court permitted this claim, limited to the period beginning in November 2007, to proceed after finding that a trier of fact would be entitled to conclude that it would have been important to a reasonable investor to know that the ARS were liquid only because auction dealers routinely intervened in the auctions, and addressing defendants' arguments related to the adequacy of disclosures made.

Having determined that plaintiffs sufficiently alleged scienter only with respect to RJA and only for the period beginning in November 2007, the court confined the rest of its analysis to misstatements or omissions made by RJA during that period and disregarded the representations made by parties not acting on RJA's behalf. Thus, because the court also found that plaintiffs had failed to properly allege a direct agency relationship between a financial advisor employed by RJFS and RJA itself, the failure to plead scienter on the part of RJFS was fatal to plaintiffs' claims against that defendant.

Further, because the only legally sufficient claim of a primary violation of the Exchange Act and Rule 10b-5 was against RJA for the period after November 2007, the court dismissed any claim under §20(a) of the Exchange Act against RJA and its parent, RJF, based on "operational and management control of RJFS," finding that the only legally sufficient §20(a) claim against RJF was for the alleged primary violation by RJA for the period beginning November 2007.

We may never be certain whether the collapse of the ARS market was a cause or an effect of the broader economic crisis, but determining whether those who marketed ARS should be liable for the losses suffered by ARS investors will depend on pleading and proof measured against increasingly stringent statutory and jurisprudential standards. As Judge Kaplan's decision demonstrates, plaintiffs in such cases may have difficulty convincing the court that the requisite state of mind may be inferred from the facts alleged because of the demanding standards for particularity under the Private Securities Litigation Reform Act.

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Endnotes:

1. *Tellabs Inc. v. Makor Issues & Rights, Ltd.*, 552 U.S. 308, 324 (2007).
2. *In re Marsh & McLennan Co. Sec. Litig.*, 501 F.Supp.2d 452 (SDNY 2006).
3. *In re Parmalat Sec. Litig.*, 337 F.Supp.2d 390, 406 (SDNY 2005).
4. RJA's financial advisor was alleged to have told one plaintiff that ARS were a "safe, short-term investment with monthly liquidity and that they were highly rated."
5. *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 267-68 (2d Cir. 1993).