

MARK P. ZIMMETT

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mzimmatt@mpzlaw.com

Memorandum to: Clients and Friends

Auction Rate Securities Litigation

In the last week of March, the United States District Court for the Southern District of New York dismissed three auction rate securities (“ARS”) fraud cases. *Oliveira v. Bessemer Trust Co., N.A.*, No. 09 Civ. 0713 (PKC), 2010 WL 1253173 (S.D.N.Y. Mar. 24, 2010 [<click to download>](#)); *Ashland Inc. v. Morgan Stanley & Co., Inc.*, No. 09 Civ. 5415 (RPP), 2010 WL 1253932 (S.D.N.Y. Mar. 30, 2010) [<click to download>](#); *In re Merrill Lynch Auction Rate Sec. Litig.*, Nos. 08 Civ. 3037 (LAP), 09 MD 2030 (LAP), 2010 WL 1257597 (S.D.N.Y. Mar. 31 2010) [<click to download>](#). (Disclosure Note: I have advised clients regarding the Merrill Lynch ARS multidistrict litigation and related cases).

All three cases were dismissed for failure to state a claim. They are the latest in a series of such dismissals.* The decisions reflect the close scrutiny of complaints under the heightened pleading standard announced by the Supreme Court in *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007), requiring plausible, not merely possible, claims. They also underscore the specificity required of fraud claims generally under Rule 9(b) of the Federal Rules of Civil Procedure and of securities fraud claims in particular under the Private Securities Litigation Reform Act of 1995, 15 U.S.C. §78 u-4(b).

Oliveira v. Bessemer Trust Co., N.A.

In *Oliveira*, the plaintiff alleged that the defendant trust company induced him to cash out a U.S. treasury note and use the proceeds to purchase ARS that he was told were short-term “safe,” “liquid,” “cash-equivalent investments.” *Oliveira*, 2010 WL 1253173 at *1-*2. The court (Castel, J.) held that the plaintiff had adequately pleaded misstatements and a failure to disclose that “the auctions were not true auctions, but instead, were supported by the ARS underwriters.” *Id.* at *4.

It is not enough, however, to plead actionable misrepresentations and non-disclosures. The complaint must also allege facts to show that the defendant acted with fraudulent intent. Fraudulent intent or scienter may be inferred from facts showing that the defendant had both a motive and opportunity to commit fraud, or from facts constituting strong circumstantial evidence of conscious misbehavior or recklessness. *Id.* Parsing the complaint’s alleged facts, the court held that the plaintiff failed to plead a fraudulent motive. But the court inferred recklessness from the allegation that the defendant was, or should have been, aware that the ARS had long maturities of over 25 years. “This knowledge would make it reckless to state that ARS were short term securities.” *Id.* at *6.

Nevertheless, the alleged fraudulent misstatement that the ARS were short-term securities did not cause plaintiff's alleged loss. The alleged drop in the value of plaintiff's ARS was "due to the failure of the auction for those securities, ...not to their maturities." *Id.* Accordingly, the securities fraud claims were dismissed.

Ashland Inc. v. Morgan Stanley & Co., Inc.

In *Ashland*, the court (Patterson, J.) dismissed the plaintiffs' securities fraud claim because it failed to meet the heightened pleading standards for scienter and failed to show plaintiffs' reasonable reliance upon defendant Morgan Stanley's highly general statements of ARS stability and liquidity. *Ashland*, 2010 WL 1253932 at *2-*3, *14. As to the latter point, the court's opinion was scolding:

Plaintiffs failed to suggest... that...[their] investment committee conducted any research or investigation into these investments or the nature of the market they were entering, how it might be connected to the subprime mortgage crisis..., and how SLARS [student loan auction rate securities] differed from purchases of short-term investments. Instead, Plaintiffs claim to have relied primarily, perhaps solely, upon general oral statements....

As a sophisticated institution contemplating the investment of tens of millions of dollars, it was unreasonable for Ashland to rely upon the highly general statements alleged as misstatements in this case. Moreover, it was unreasonable, perhaps reckless, for that company to not insist upon receiving, in writing, the prospectus...and terms of purchase before making its initial investment of thirty million dollars.... For a company that invested well over sixty million dollars in a two-month period in a complicated investment vehicle to rely upon the broker's general statement that, for example, the investment was "unrelated to current problems" is fundamentally unreasonable. The Second Circuit has found that investors must exercise minimal diligence for reliance to be said to be reasonable. Here, there is no allegation that Plaintiffs exercised any diligence.

Id. at *13-*14 (citations omitted).

In re Merrill Lynch Auction Rate Sec. Litig

In *Merrill Lynch*, the court (Preska, J.) dismissed for a number of reasons a securities fraud class action claim brought on behalf of ARS purchasers. The complaint failed to specify who made the allegedly false and misleading statements to whom, where and when. *Merrill Lynch*, 2010 WL 1257597 at *8. The court further dismissed plaintiffs' market manipulation claim because it held that the alleged manipulation had been adequately disclosed. Plaintiffs complained that Merrill had propped up the auction market for its own underwritten ARS through undisclosed bidding for its own account. However, the court found that the support bid practice was adequately disclosed in a 2006 SEC Cease and Desist Order and on Merrill's own website. "The market is not misled when a transaction's terms are fully disclosed. *Id.* at *10. In addition, the Cease and Desist Order, website notice and other disclosures (research reports and prospectuses) belied justifiable reliance on the alleged misrepresentations and rebutted the presumption of reliance arising from an alleged fraud on the market. *Id.* at *15-*22.

I hope you find these cases interesting and useful.

* See, e.g., *Ashland Inc. v. Oppenheimer & Co., Inc.*, 09 Civ. 135 (JBC), 2010 WL 672106 (E.D. Ky. Feb. 22, 2010); *Mayor of Baltimore v. Citigroup, Inc.*, Nos. 08 Civ. 7746 (BSJ), 08 Civ. 7747 (BSJ), 2010 WL 430771 (S.D.N.Y. Jan. 26, 2010); *Healthcare Finance Group, Inc. v. Bank Leumi USA*, No. 08 Civ. 11260 (VM), 2009 WL 3631036 (S.D.N.Y. Oct. 26, 2009); *Cornwell v. Credit Suisse Group*, No. 08 Civ. 3758 (VM), 2009 WL 3241404 (S.D.N.Y. Oct. 5, 2009); *Defer LP v. Raymond James Financial, Inc.*, No. 08 Civ. 3449 (LAK), 2009 U.S. Dist. LEXIS 84685 (S.D.N.Y. Sept. 17, 2009); *In re Citigroup Auction Rate Sec. Litig.*, No. 08 Civ 3095, 2009 U.S. Dist. LEXIS 83046 (S.D.N.Y. Sept. 11, 2009); *Louisiana Municipal Police Employment Retirement Systems v. Pandit*, No. 08 Civ. 7389 (LTS) (RLE), 2009 WL 2902587 (S.D.N.Y. Sept. 10, 2009); *Aimis Art Corp. v. Northern Trust Sec., Inc.*, No. 08 Civ. 8057 (VM), 2009 U.S. Dist. LEXIS 68712 (S.D.N.Y. Aug. 6, 2009); *Louisiana Municipal Police Employment Retirement Systems v. Blankfein*, No. 08 Civ. 7605 (LBS) 2009 WL 1422868 (S.D.N.Y. May 19, 2009); *In re UBS Auction Rate Sec. Litig.*, No. 08 Civ. 2967 (LMM), 2009 U.S. Dist. LEXIS 26385 (S.D.N.Y. Mar. 30, 2009).

Mark P. Zimmet
Law Offices of Mark P. Zimmet
126 East 56th Street
New York, New York 10022
Tel. No.: (212) 755-0808
Fax No.: (212) 755-0888
mzimmet@mpzlaw.com
www.mpzlaw.com