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Title: **EXPANDING RESPONSIBILITIES: RECENT DISCLOSURE ACTIONS INVOLVING MUNICIPAL SECURITIES ISSUERS**

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EXPANDING RESPONSIBILITIES:

RECENT DISCLOSURE ACTIONS INVOLVING MUNICIPAL SECURITIES ISSUERS

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Securities law application to state and local governments has been a fixture of the municipal bond market for the three decades since the New York City moratorium. Altogether this author counts 75 enforcement actions against issuers and obligated persons and 54 against officials. That count excludes dozens of private actions.

Within the past 12 to 15 months, significant developments have occurred with substantial implications for issuers and officials and for their methods of financing their projects and programs.

To begin, the SEC has now imposed the first monetary penalty against an issuer in an enforcement action, and issuers (and even governing board members) have paid or agreed to pay substantial monetary settlements in private actions.

In addition, the Commission has advanced arguments against both a financial advisor and a lawyer focusing on asserted failures to render advice to issuers covering a broad range of subjects. The arguments characterize such failures as important elements in securities law violations asserted by the Commission against those professionals.

The bottom line is that the actions pursued and arguments advanced by the Commission and private investors require everyone involved in municipal finance transactions—issuers and professionals alike—to pay closer attention to the intricacies of disclosure content and the inquiry and disclosure processes.

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Mr. Doty served as a consultant to legal counsel to various parties, and as an expert witness, in certain matters discussed in this paper.

Responsibilities of Issuers

The recent actions expanded issuers' disclosure horizons in important ways.[2] The general rule expressed by the SEC as to issuer responsibilities is as follows:

> [I]ssuers are primarily responsible for the content of their disclosure documents and may be held liable under the federal securities laws for misleading disclosure. … Because they are ultimately liable for the content of their disclosure, issuers should insist that any persons retained to assist in the preparation of their disclosure documents have a professional understanding of the disclosure requirements under the federal securities laws.[3]

A Director of the SEC's Office of Municipal Securities later explained the Commission's posture, as follows:

> The Commission has pointed out for a long time that issuers are primarily responsible for disclosure. *No one knows better than the issuer where the closets are, or what skeletons may be in the closets.* No professional mind can read as to where they may be.[4]

Responsibilities of Officials

With respect to issuer officials, the SEC outlined its view of basic responsibilities in a Staff Report relating to the County Supervisors of Orange County, California, following the County's bankruptcy filing:

> [T]he Supervisors approved Official Statements that, among other things, failed to disclose certain material information about Orange County's financial condition that brought into question the County's ability to repay its securities absent significant interest income from the County Pools. *The Supervisors were aware of material information* concerning Orange County's financial condition; this information called into question the County's ability to repay its securities. Nevertheless, *the Supervisors failed to take appropriate steps to assure disclosure of these facts.* In light of these circumstances, the Board members *did not fulfill their obligations* under the antifraud provisions of the federal securities

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[2] Various documents, including SEC releases, cited in this paper are available at *http://www.agfs.com/securitieslaws.asp*.

This paper describes information known to the author as of September 3, 2004.

[3] SEC Rel. No. 34-26985, 54 F.R. 28799, 28811 n.84 (July 10, 1989).

[4] Transcript of The Bond Buyer's First Annual Buyers Symposium, June 7, 1995, comments of Paul S. Maco, Director of Office of Municipal Securities, Securities and Exchange Commission, reprinted in The Bond Buyer at 5A (Aug. 7, 1995).

laws in authorizing the issuance of the municipal securities and related disclosure documents.[5]

The SEC's Staff observed that the Supervisors did not review final versions of official statements they approved or inquire about disclosure of significant information known to them:

> Despite their knowledge of the County's increasing use of interest income from the County Pools to balance the discretionary budget, the Supervisors approved the Official Statements for the various offerings without taking steps to assure disclosure of this information. *They never received or asked to receive a copy of any Preliminary Official Statement once finalized, or any final Official Statement; nor did they question the County's officials, employees or other agents concerning the disclosure regarding the County's financial condition.* Thereafter, the Supervisors chose to authorize and approve approximately $1.3 billion of municipal securities offerings.[6]

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[5] **REPORT OF INVESTIGATION IN THE MATTER OF COUNTY OF ORANGE, CALIFORNIA AS IT RELATES TO THE CONDUCT OF THE MEMBERS OF THE BOARD OF SUPERVISORS**, SEC Rel. No. 34-36761 at Section I (Jan. 24, 1996). [Emphasis added.]

[6] *Id.* at Section IV [Emphasis added.]

In the Report at Section III, the SEC's Staff made the following factual observations:

> [T]he County retained financial advisers, bond counsel and underwriters to assist in these municipal securities offerings. The County also retained a national accounting firm to audit the County's financial statements. The Supervisors approved the retention of these professionals. *While the Supervisors believed that they could rely on these professionals, the Supervisors never questioned the professionals regarding the disclosure in the Official Statements*, despite their knowledge of facts calling into question the County's ability to repay the securities.
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> In preparation for Board meetings, the Supervisors and/or their executive assistants attended weekly briefings regarding the items on the upcoming agenda, which might consist of 100 or more items. These briefings generally lasted between one and two hours and were conducted by the County Administrative Officer and/or his staff. Prior to the briefing, the County Administrative Officer reviewed each agenda item, including those concerning the securities offerings, and typically concurred with the recommendations made by the Treasurer. The County Administrative Officer's review was principally focused on ensuring that the agenda item was consistent with both the adopted budget and the Board's policies.
>
> The Supervisors' executive assistants reviewed the Agenda Item Transmittals and occasionally the back-up documentation. The level of review performed by an executive assistant varied considerably, ranging from mere receipt of the Agenda Item Transmittal to reviewing and summarizing both the Agenda Item Transmittal and back-up documentation, when such documentation was available.
>
> The level of review performed by each Supervisor varied. For example, some of the Supervisors reviewed the Agenda Item Transmittal and summaries of the Agenda Item Transmittal back-up documentation; however, *no Supervisor recalled reading any of the draft Preliminary Official Statements or related documents*. At least one Supervisor did not review any written documentation and instead relied on the County Administrative Officer and his staff and that Supervisor's executive assistant for advice on how to vote.

The Report concludes that members of issuer governing boards must accept personal responsibility for review of the issuers' disclosure documents:

> A public official who approves the issuance of securities and related disclosure documents may not authorize disclosure that the public official knows to be materially false or misleading; nor may the public official authorize disclosure while recklessly disregarding facts that indicate that there is a risk that the disclosure may be misleading. *When, for example, a public official has knowledge of facts bringing into question the issuer's ability to repay the securities, it is reckless for that official to approve disclosure to investors without taking steps appropriate under the circumstances* to prevent the dissemination of materially false or misleading information regarding those facts. In this matter, *such steps could have included becoming familiar with the disclosure documents and questioning the issuer's officials, employees or other agents about the disclosure of those facts*.[7]

Taken as a whole, the actions discussed in this paper expand upon the foregoing principles and underscore for issuers and officials the importance of inserting themselves directly and actively into the disclosure process. Certainly, the SEC's actions and issuer (and official) liabilities point strongly in that direction.

Critical Lessons for Issuers and Officials

The actions discussed in this paper illustrate a number of critical lessons for issuers:

- Although some may seek to minimize potential issuer liability risks, litigation costs, as well as remedies, can be appalling; issuers and officials should take those risks very seriously when bond issues are structured and marketed
- Issuers (and officials) can be exposed to actual monetary liabilities
- Issuers (and officials) cannot simply rely on legal and financial professionals when one or more issuer officials know of, or have substantial notice as to, potential misstatements of material information in, or omissions of material information from, disclosure documents
- When officials know material information, they should assure themselves that it is appropriately disclosed (even if the officials do

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Each of the six offerings was placed on the Board's "consent calendar" which contained the vast majority of the agenda items. *Each of the subject offerings was approved by consent.* [Emphasis added.]

[7] *Id.* at Section V [Emphasis added.]

not recognize that the information is material to investors' decisions)[8]

- Material information that is ambiguous or uncertain nevertheless should be disclosed with careful attention to describing the ambiguities or uncertainties
- Present intentions for future actions can be material, and in such cases, should be disclosed with appropriate cautions as to factors that may alter the outcome
- Even statements that are literally accurate may mislead due to omission of material information
- General disclosure of risks omitting specific known or readily-available material information is not acceptable disclosure
- Information should not be presented as uncertain when material information is certain (and vice versa)
- Closing certificates containing issuer representations to transaction participants may be cited in litigation as disclosure documents
- Governmental issuers and officials can be subject to remedies, even when principal parties in bond issues, such as private developers or companies in land-based or conduit financings, commit their own securities law violations
- Expert studies, reports, analyses and audits do not insure against liabilities; should not be accepted from conflicted experts; should be reviewed carefully (especially the assumptions and methodology); should contain the expert's professional opinions that assumptions upon which such work products are based are reasonable; and should be used only with the experts' explicit consents

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[8] It is at this juncture that a significant disconnect exists between the Commission and many local officials. In general, information is considered to be "material" under the federal securities laws, if it would affect the investment judgment of a reasonable investor. That is, as to an omitted fact, the fact is "material," if the "omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449, 96 S.Ct. 2126, 2132, 48 L.Ed.2d 757 (1976); *Basic Inc. v. Levinson*, 485 U.S. 224, 232, 108 S.Ct. 978, 983, 99 L.Ed.2d 194 (1987).

Many local officials, however, are average citizens and are not investors. They do not know necessarily whether particular information would affect investors' investment judgments. Thus, a local official may well know information that happens to be "material," and that is not disclosed, and yet not recognize the need for disclosure of that particular information.

Historically, in the municipal securities market, many local officials have viewed themselves as unqualified to make disclosure judgments, and have relied heavily and directly upon legal and financial professionals to make those judgments on the issuers' behalves. As described in this paper, the Commission's positions commonly discount that reliance.

- Insured bonds do not protect against SEC actions, and bond insurers are filing litigation alleging misrepresentations against various parties, including issuers, and underwriter failures to perform investigatory duties alleged to have been owed to the insurers
- State securities laws also create significant responsibilities and risks for issuers (and officials)

Disturbingly, despite those considerations and the SEC's positions, one recent commentary published by Bloomberg news[9] cited results of a survey by William P. Kittredge of the newly-created nonprofit Center for the Study of Capital Markets and Democracy suggesting that many issuers and officials still may not undertake key steps vital to their own interests. According to Bloomberg's Joe Mysak,

> In response to the question, "Does your debt policy require or encourage elected officials to thoroughly read the official statement to a bond issue prior to approval?" 53 percent of finance officers replied no.

The survey is not likely a scientific one. We do not know either what finance officers who did not respond to the survey would say about their debt policies or whether some elected officials might read carefully official statements they approve, even if their debt policies do not require or encourage that action. Nevertheless, the results do not reflect the desirable widespread issuer awareness of the SEC's postures or of risks of approving disclosure documents without careful and detailed official review.

Yet, given the recent actions, reading official statements is not the end of an issuer official's responsibilities. Neither is it sufficient to ask questions without carefully evaluating responses and disclosure in the light of known or readily-available information.

Interestingly, in several instances cited in this paper, issuers did seek expert studies, ask questions, and conduct or press for investigations of information.[10] The issuers' antagonists—the SEC or private investors—asserted, however, that expert studies or investigations were flawed, reliance on professionals and experts was inappropriate, or issuers did not disclose information known, or that should have been known, to them.

The recent actions discussed in this paper reinforce the reasons why such reviews are essential.

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[9] Mysak, "*Municipal Market Goes Under the Magnifying Glass*," Bloomberg News (Apr. 16, 2004).

[10] In **QUESTIONS TO ASK BEFORE YOU APPROVE A BOND ISSUE, A POCKET GUIDE FOR ELECTED AND OTHER PUBLIC OFFICIALS**, prepared by the National League of Cities; the National Association of Counties; the National Association of State Auditors, Comptrollers and Treasurers; and the Government Finance Officers Association with input from the Securities and Exchange Commission, issuers are urged to ask questions of their municipal finance professionals.

A number of the issuers described in this paper did so, and as discussed in the text accompanying n. 45, *infra*, one issuer even received a legal opinion approving the actions to be taken by the issuer.

Cautions to Bond Professionals as to Need for Affirmative Advice to Issuers

In some actions discussed in this paper, local officials did not read documents they signed at closing or official statements they approved.

Some 15 years after first asserting issuers' "primary" responsibility for their disclosure documents, and perhaps realizing how local officials often are continuing to approach their documents, the Commission appears to have decided on a new tack. As discussed in this paper, the SEC's Division of Enforcement is arguing that bond professionals should advise issuers affirmatively and explicitly as to the issuers' duties, as to relevant legal and financial considerations, and that particular information must be disclosed.[11]

Decisions are still pending in two actions in which such arguments have surfaced. Nevertheless, municipal bond professionals, both legal and financial, need to consider, for the professionals' own protection (at least in "riskier" transactions), rendering advice to issuers and officials as to the SEC's views in a number of areas, including the following:

- Primary responsibility of issuers for the material accuracy and completeness of their disclosure documents
- Potential liability of issuers and officials for disclosure violations
- Inability of issuers and officials simply to rely on the advice of their professionals in making disclosure decisions
- Need for officials to review carefully, in the light of information known or readily-available to the officials, the official statements they approve and the documents (and especially the representations) they sign[12]
- Tax law (and presumably other sensitive legal requirements) applicable to the issuers in the transactions, including descriptions of how those requirements apply to the issuers[13]

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[11] See the text accompanying nn. 56-59 and 75-79, *infra*.

[12] This would require, of course, that officials have the documents sufficiently in advance of their approvals and signing in order to read the documents, understand them, and ask questions. The practices of some professionals of submitting documents shortly prior to meetings, or of bringing copies to the meetings, for governing board action are unwise regardless of perceived time pressures.

If the documents cannot be prepared so as to give governing board members time to review and understand them, those bond transactions simply need to be delayed.

Further, it would appear advisable for legal and financial professionals to spend time meeting with issuer officials in order to explain documents and applicable legal and financial considerations and to provide adequate opportunity for discussion and questions.

[13] See n. 12, *supra*, regarding meeting with, discussing and offering opportunities for questions regarding applicable legal and financial issues affecting issuers' interests.

- When transactions involve particular risks, what the risks are and how they could affect the issuers' interests[14]
- Need for transactional risks to be disclosed to investors
- Need for disclosure of other specific material information
- How appropriate disclosures would protect the interests of the issuers and officials

Without such affirmative and explicit advice, it now appears that legal and financial professionals may expose themselves, at least in riskier bond issues, to charges in enforcement actions of causing, or aiding or abetting, issuer federal securities law violations.

Although many transactions may be considered, when viewed prospectively, not to be "risky," with hindsight, any transaction that encounters serious problems is likely to appear to appear so. It is difficult to articulate a significant reason for professionals to fail to render such advice generally in their professional representations of issuers.

Neshannock Township School District

Background

After a period of quiet relating to SEC enforcement proceedings targeting small and inexperienced issuers, issuer risks were heightened in the SEC's recent action against a small Pennsylvania school district, Neshannock Township School District.[15]

In that enforcement action, the SEC, for the first time, went beyond merely ordering the issuer to cease and desist committing antifraud violations, but imposed the added monetary penalties of disgorgement[16] and prejudgment interest.[17] The IRS had determined previously that interest on the District's notes was taxable, resulting in redemption of the notes at the first call date and in another payment by the District to the IRS to preserve the tax-exempt status of the notes.[18]

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[14] See, *e.g.*, text accompanying 75-79, *infra*, regarding an argument advanced that a financial advisor should have cautioned an issuer regarding the risks of selling unrated bonds.

[15] *In the Matter of Neshannock Township School District*, SEC Rel. Nos. 33-8411, 34-49600 (Apr. 22, 2004).

[16] Disgorgement is a remedy pursuant to which the District was required to relinquish "ill-gotten gains," as opposed to paying damages to investors. Indeed, it appears that no investors experienced any actual monetary losses, since a payment was made to the IRS to preserve the tax-exemption of interest on the District's notes.

[17] Prejudgment interest is interest accruing on the amount paid pursuant to the basic monetary remedy (in this action, disgorgement) prior to the determination that money should be paid.

[18] *In the Matter of Neshannock Township School District*, SEC Rel. Nos. 33-8411, 34-49600 at ¶7 (Apr. 22, 2004).

The Neshannock District engaged in an issuance of three-year notes, proposed by an underwriter, purportedly for the purpose of financing capital projects. Although the District had a general intention to construct projects at some time, that intention was "exploratory," and the projects were ill-defined and were not prioritized at the date of note issuance.[19] The District had not conducted a demographic study "needed to justify" the project, and had not "formally hired" an architect.[20] The District invested the proceeds of sale of the notes almost to the notes' maturity.

The District's actions presented questions about the tax exemption for the notes. Federal tax rules afford a temporary period during which proceeds may be invested at a higher yield than the yield on the tax-exempt securities, but that assumes an intention to use the proceeds for projects within the context of defined expenditure targets.

Inquiry of Professionals

The District's board members had warning that there could be problems with the transaction, although the Commission did not cite the warning in its release. One board member testified that she had heard warnings about such transactions voiced at a conference.[21] Indeed, some board members "were initially skeptical about the financing proposal" and "raised questions"[22] with the underwriter and with bond counsel, whom the District had employed upon the underwriter's recommendation.[23]

District officials "had explicitly" advised bond counsel[24] that the District "had not made any final decisions on its primary capital project," and in addition, that the District "did not want to be locked into undertaking" a "controversial project." Bond counsel allegedly "reassured" the officials that "as long as they 'intended' to undertake" the project, they were "not actually required to spend the money or to do the project in order to keep the arbitrage profit."[25]

After those discussions, the school board unanimously approved the transaction. In the process, the District made inaccurate representations in the District's Official

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[19] *In the Matter of Neshannock Township School District*, SEC Rel. Nos. 33-8411, 34-49600 at ¶4 (Apr. 22, 2004).

[20] *Id.*

[21] Hume, "*SEC Case: School Officials Say Weiss Didn't Counter Shupe Plan,*" The Bond Buyer Online (July 14, 2004).

[22] *In the Matter of Neshannock Township School District*, SEC Rel. Nos. 33-8411, 34-49600 at ¶4 (Apr. 22, 2004).

[23] *In the Matter of Weiss and Shupe*, SEC Admin Proc. No. 3-11462 at Section F, ¶1 (Order Instituting Proceedings, Apr. 22, 2004).

[24] To minimize confusion regarding roles of parties, this paper uses the term "bond counsel" as to this counsel. The SEC's release refers to the counsel as "Note Counsel."

[25] *In the Matter of Weiss and Shupe*, SEC Admin Proc. No. 3-11462 at Section A (Order Instituting Proceedings, Apr. 22, 2004).

Statement and also in a closing tax certificate.[26] The certificate, which had been drafted by bond counsel, contained representations of the District to the effect that the District intended to expend funds on capital projects, so as to meet specified expenditure targets.[27]

District Misrepresentations

The SEC concluded that the District had made misrepresentations and should have disclosed to investors resulting risks to the tax-exempt status of the bonds. In that regard, specific misrepresentations by the District are identified in the SEC's release:

> **5.** As of the date of closing on the Notes, a School District official executed an inaccurate non-arbitrage certificate, drafted by [Bond] Counsel, to the effect that, among other matters, the School District reasonably expected **(i)** within six months to enter into a binding obligation to expend at least five percent of the Note proceeds on the costs of capital projects, and **(ii)** within three years to expend eighty-five percent of the Note proceeds on capital projects. In fact, although the School District did intend at some point to proceed with the capital projects, the School District was not certain when it would enter into any binding obligations and had not planned to spend a significant portion of the Note proceeds within three years.
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> **6.** The School District offered its Notes to potential investors through its Official Statement, signed by a representative of the School District. The Official Statement represented that the net proceeds from the sale of the Notes would be used to provide funds for capital improvement projects of the School District. In fact, shortly after the closing on the Notes and upon the advice of the Underwriter, the School District invested the net Note proceeds in a Federal Home Loan Bank obligation maturing within sixty days of the maturity date for the Notes. Moreover, in a separate section entitled "Not Arbitrage Notes," the Official Statement highlighted the existence of the inaccurate non-arbitrage certificate described above. According to the Official Statement, the School District would issue its certificate to the effect that the proceeds of the Notes would not be used in a manner that would cause the Notes to be or become "arbitrage notes," as described in Section 148 of the tax code. The Notes were

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[26] A tax certificate is a lengthy and highly complex document delivered at the closing of a tax-exempt securities issue. Among other things, the certificate generally contains an issuer's representations as to the use of the proceeds of sale of the securities, and as to how, and the conditions under which, funds are intended to be invested. Due to its complexity, a tax certificate is almost always prepared by bond counsel based on discussions with the issuer and other transaction participants. The complexity of the arcane language of such a certificate is such as to make it virtually incomprehensible to a layperson in the absence of extensive detailed review. Many governmental officials may not understand the complexity and arcane language even then.

In this instance, the critical District representations were on page 6 of a 13-page certificate. *In the Matter of Weiss and Shupe*, SEC Admin Proc. No. 3-11462 at Section F, ¶14 (Order Instituting Proceedings, Apr. 22, 2004).

[27] *In the Matter of Neshannock Township School District*, SEC Rel. Nos. 33-8411, 34-49600 at ¶5 (Apr. 22, 2004).

offered at interest rates commensurate with their purported tax-exempt status. The Official Statement did not accurately describe the use of the Note proceeds, and did not disclose the resulting risk to the Notes' purported tax-exempt status.

7. The School District did not enter into any formal commitment to expend any portion of the Note proceeds within the six month time period, nor did it expend any portion of the net Note proceeds on any capital project. In November 2000, the Internal Revenue Service ("IRS") commenced an examination of the Notes. Shortly thereafter, the School District decided to redeem the Notes on May 15, 2001, the first call date. The redemption price for the Notes was paid from the proceeds of the Notes. In September 2001, the IRS issued a preliminary determination that the Notes were taxable arbitrage notes. In the IRS's view, the School District had issued the Notes without any reasonable expectation to expend the proceeds on capital projects. The School District and the IRS entered into a closing agreement that, among other things, provides for a payment by the School District to the IRS and preserves the tax-exempt status of the Notes. The closing agreement also provides that it is not to be construed as an admission by the School District that it acted wrongly with respect to the Notes.[28]

Levels of Fault

While the Commission identified misrepresentations allegedly committed by the School District, we are not told how the District was at fault, other than misstating or failing to disclose material information. In that regard, the Commission asserted[29] that the District violated Section 17(a)[30] of the Securities Act of 1933 and Rule 10b-5[31] adopted under Section 10(b)[32] of the Securities Exchange Act of 1934.

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[28] *In the Matter of Neshannock Township School District,* SEC Rel. Nos. 33-8411, 34-49600 at ¶¶5-7 (Apr. 22, 2004).

[29] *In the Matter of Neshannock Township School District*, SEC Rel. Nos. 33-8411, 34-49600 at ¶12 (Apr. 22, 2004).

[30] Section 17(a) provides:

> **(a)** It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
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> **(1)** to employ any device, scheme, or artifice to defraud, or
>
> **(2)** to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> **(3)** to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

[31] Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> **(a)** To employ any device, scheme, or artifice to defraud,

Section 17(a) requires differing levels of fault as elements of a violation, including as to Section 17(a)(1), *scienter*,[33] and as to Sections 17(a)(2) and (3), negligence.[34] Rule 10b-5 requires scienter for a violation.[35]

> **(b)** To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> **(c)** To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

[32] Section 10(b) provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> **(b)** To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

[33] *Aaron v. SEC*, 446 U.S. 680, 100 S.Ct. 1945 (1980).

Scienter is generally applied so as to require either intentional action or recklessness. A common test of recklessness was stated by the Ninth Circuit in *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569 (quoting *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977), as

> a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.

See also *In re Livent, Inc. Noteholders Securities Litigation*, 151 F.Supp.2d 371, 410-12 (S.D.N.Y. 2001) (at 411, "even inexcusable negligence will not suffice"); *In re Advanta Corp. Securities Litigation*, 180 F.3d 525, 535 (3d Cir. 1999); *In re Comshare Inc. Securities Litigation*, 183 F.3d 542, 550 (6th Cir. 1999) ("akin to conscious disregard").

In its *Sundstrand* decision cited above, the Seventh Circuit made the following statement:

> [t]he danger of misleading buyers must be actually known or so obvious that any reasonable man would be legally bound as knowing,[19] and the omission must derive from something more egregious than even "white heart/empty head" good faith.[20]

The Court continued in the footnotes to the foregoing description:

> [19] This is an objective test although the circumstances must be viewed in their contemporaneous configuration rather than in the blazing light of hindsight.
>
> [20] This is a subjective test with the requirement of something more than "inexcusable negligence" imposed because of *Hochfelder*. 425 U.S. at 190 n 5, 96 S.Ct. 1375. Thus, if a trial judge found, for example, that a defendant genuinely forgot to disclose information or that it never came to his mind, etc., this prong of the … test would defeat a finding of recklessness even though the proverbial "reasonable man" would never have forgotten.

The Commission does not discuss in the *Neshannock* release whether the District intended to commit fraud or had an awareness that the information was material or whether the District was negligent (*i.e.*, that the District departed in some manner from the applicable standard of care) or was reckless (*i.e.*, that the District departed in an extreme manner departed in an extreme manner from the applicable standard of care) in not recognizing that "materiality." Instead, the Commission largely assumed the element of fault.

Yet, as noted in note 33 to this paper, the Seventh Circuit stated, as to recklessness:

> if a trial judge found, for example, that a defendant genuinely forgot to disclose information or that it never came to his mind, etc., this prong of the … test would defeat a finding of recklessness even though the proverbial "reasonable man" would never have forgotten.[36]

The Commission's approach poses substantial dangers for well-meaning local officials who want to take appropriate action, but who lack the sophistication or expertise to challenge legal and financial professionals advising the officials, explicitly or by silence, that all applicable requirements have been satisfied.

Testimony reported in the trial against the District's bond counsel indicated that District officials signed documents without reading them.[37] Perhaps that could indicate a deliberate refusal to consider informational accuracy. Yet, the Commission does not cite such facts or other similar facts in its release. While it is helpful to have the Commission's description of the District's knowledge and an identification of the specific inaccurate information the District should have recognized and disclosed, it would be helpful as well to understand why the District should have known that the information was material, especially after the discussions with bond counsel and the underwriter.

Thus, the SEC's Neshannock release highlights monetary risks for municipal issuers, even when officials affirmatively ask questions and receive assurances from legal and financial professionals, and even when investors do not incur losses. District

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Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 and nn. 19-20 (7th Cir. 1977), *cert. denied*, 434 U.S. 875, 98 S.Ct. 224, 54 L.Ed.2d 155 (1977).

[34] *Aaron v. SEC*, 446 U.S. 680, 100 S.Ct. 1945 (1980).

In *SEC v. Dain Rauscher, Inc., et al*., 254 F.3d 852, 854 (9th Cir. 2001), the Ninth Circuit stated the following test relating to a negligence level of fault:

> We hold that the standard of care for an underwriter of municipal offerings is one of *reasonable prudence*, for which the industry standard is one factor to be considered, but it is not the determinative factor.

[35] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 96 S.Ct. 1375 (1975).

[36] See n. 33, *supra*.

[37] See the text accompanying n. 54, *infra*.

statements in its Official Statement and closing tax certificate, while perhaps appearing superficially accurate to some District officials due to the District's general intentions to construct projects of some nature at some time,[38] were not materially accurate, in the SEC's view, and District officials did have a warning, not cited by the SEC, contrary to those representations.

Precedent

The Commission's approach of using closing certificates as elements of a securities law violation follows precedent. The notion that a closing certificate can serve as a disclosure document had been espoused several years earlier against numerous small general governmental issuers in Mississippi, in the context of similar note financings. In those actions, the Commission expressed the following analysis:

> Bond counsel provided the respective issuers with all of the necessary documents, including, but not limited to *resolutions, official statements, and arbitrage certificates.* These documents were signed by the chief executives of the respective issuers. *Those chief executives signed the various documents*, when they knew or were reckless in not knowing that the documents contained misrepresentations regarding the municipalities' intention to utilize the note proceeds for capital projects. *Certain of the respective chief executives and other officials failed to read the documents before signing or authorizing them, relying on bond counsel* to ensure that the factual representations being made by the Respondent were accurate.[39]

Important aspects of that analysis were reiterated contemporaneously in the SEC's action against the City of Ione, California, which was considered responsible for a private developer's information in connection with two land-based financings. The Commission did not allege that Ione was aware of the information, implying a City duty to conduct an affirmative investigation of the developer's information. For example, the developer had made undisclosed draws on a line of credit represented to the City as an important credit element of the transaction for payment of development costs. The City also was considered responsible for assumptions, deemed inappropriate by the SEC, in an appraisal prepared by a professional appraiser.

Minutes of City Council meetings demonstrate that Ione's Council members had asked questions and sought information, even conducting a special "workshop" to discuss the transaction. The minutes also show that Council members were assured that the transaction was conservative and further that the City had "triple hit" protection in the form of the participation of bond counsel, the underwriter and underwriter counsel.

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[38] As discussed in text accompanying n. 54, *infra*, at least some District officials appear not to have reviewed documents they signed.

[39] *In the Matter of Coahoma County, MS, et al*., SEC Rel. Nos. 33-7554, 34-40194 (July 13, 1998). [Emphasis added.]

The Commission disputed the City's reliance on the appraiser and on counsel for the preparation of Ione's official statement, as follows:

> Even though it retained and relied upon professional financial and legal advisers and appraisers, Ione was responsible under [Securities Act of 1933] Sections 17(a)(2) and 17(a)(3) for any misrepresentations and/or omissions in the CFD-1 and CFD-2 Official Statements. The Ione City Council approved both Official Statements.[40]

Reliance on Counsel

There is, in fact, a line of legal analysis as to when issuers (and others) are permitted to rely upon the advice of professionals. Even then, appropriate reliance does not necessarily provide absolute protection against liability, but rather may be considered as a factor in the totality of the facts and circumstances.[41]

The elements of reliance upon professionals were set forth by Administrative Law Judge Brenda Murray in her decision in the action brought by the Commission against the City of Miami:

> To establish a good faith reliance defense based on the advice of an accountant or an attorney, one must show that she **(1)** made complete disclosure, **(2)** sought the advice as to the appropriateness of the challenged conduct, **(3)** received advice that the conduct was appropriate, and **(4)** relied on the advice in good faith. … The City has not satisfied those elements. First, when it made the three bond offerings and when it distributed its 1994 CAFR, *the City did not ask for, receive, or rely on* advice from *Deloitte* [the auditors] *as to whether its financial status had changed materially* from what was shown in its 1994 Financial Statements dated February 28, 1995. …
>
> Most important, when it took these actions in late March, June, August, and December 1995, the City knew that the information it was providing investors and potential investors did not fully and accurately describe its financial situation at those particular times. *It is well-settled case law that a person cannot claim reliance on another when the person knowingly makes fraudulent statements and intentionally omits information about material subjects.* …[42]

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[40] *In the Matter of County of Nevada, City of Ione, et al.*, Sec Rel. No. 33-7537 (May 5, 1998) [as to City of Ione]. See also *In the Matter of the County of Nevada, et al.*, SEC Rel. No. 33-7535 (May 5, 1998) [as to Nevada County].

[41] *SEC v. Goldfield Deep Mines Co*., 758 F.2d 459, 467 (9th Cir. 1985).

[42] *In the Matter of the City of Miami*, SEC Initial Decision Rel. No. 185 at text following n. 45 (June 22, 2001, *aff'd*. by the Commission, SEC Rel. No. 33-8213, 34-47552 at n. 40 and accompanying text (March 21, 2003). [Emphasis added.] See also *SEC v. Caserta*, 75 F. Supp.2d 79 (E.D. N.Y. 1999); *SEC v. Goldfield Deep Mines Co*., 758 F.2d 459, 467 (9th Cir. 1985).

In affirming Judge Murray's opinion, the Commission stated:

> Miami further asserts that the City relied on Deloitte, and other professionals who participated in the bond offerings, to advise the City on its disclosure in the Official Statements. Primary responsibility for the accuracy of information filed with the Commission and disseminated among investors rests upon the municipality. *A city does not discharge this obligation by the employment of independent public accountants or other professionals. As we have repeatedly emphasized, issuers of municipal securities "are primarily responsible for the content of their disclosure documents* and may be held liable under the federal securities laws for misleading disclosure." *Municipal issuers have an affirmative obligation to know the contents of their securities disclosure documents*, including their financial statements.[43]

The Commission added:

> Even if [auditor personnel] drafted [a key statement in a note to Miami's financial statements], however, Miami knew that [the key statement] did not disclose the scope of its cash flow predicament or the necessity to issue debt to remedy that problem. If a company officer knows that "financial statements are false or misleading and yet proceeds to file them, the willingness of an accountant to give an unqualified opinion with respect to them does not negative the existence of the requisite intent or establish good faith reliance."[44]

A literal reading of Judge Murray's and the Commission's lines of analysis could be problematic for issuers who assume that the issuance of legal opinions by disclosure counsel or underwriter counsel affords the issuers protections. For one thing, underwriter counsel do not represent the issuers, and generally are not in a contractual or fiduciary relationship with the issuers. In addition, opinions of underwriter counsel usually are not addressed to the issuers.

Further, such opinions of disclosure counsel and underwriter counsel typically exclude broad areas of relevant information (*e.g.*, financial and statistical information that are often central to securities law litigation). Some opinions have gone so far as to exclude anything in appendices to an official statement. Such exclusions offer an opportunity for negotiation that issuers, being virtually oblivious to the question, almost never use to their benefit.

The opinions are usually in the form of negative assurances (based upon specific areas of review, "nothing has come to our attention"). Perhaps most importantly, noting

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[43] *In the Matter of the City of Miami*, SEC Rel. No. 33-8213, 34-47552 at nn. 40-44 and accompanying text (Opinion of the Commission, March 21, 2003). [Notes omitted; emphasis added.]

[44] *In the Matter of the City of Miami*, SEC Rel. No. 33-8213, 34-47552 at text accompanying n. 46 (Opinion of the Commission, March 21, 2003). The Commission's note reads as follows: *See U.S. v. Erickson*, 601 F.2d 296, 305 (7th Cir. 1979) (criminal case); *See U.S. v. Colasurdo*, 453 F.2d 585, 594 (2nd Cir. 1971). *See also Mishkin v. Peat, Marwick, Mitchell & Co.*, 744 F. Supp. 531, 538 (S.D.N.Y. 1990) (management is responsible for entity's financial statements).

the specificity of advice required in Judge Murray's analysis, it is likely to be rare that an issuer will receive a legal opinion or professional advice on a specific question relating to disclosure of particular information. An issuer often will have knowledge or notice of information, but will assume, without asking explicitly, that legal counsel will cause disclosure of the information, if counsel concludes that the information is "material."

Given the highly restrictive elements of the defense of reliance on counsel, issuers may wish to begin seeking affirmative formal written legal opinions on specific subjects. Even then, however, if issuers and officials know information (but not necessarily that the information is "material"), they still may be at risk.

For example, in the case of the Neshannock District, bond counsel appears to have rendered precisely such a specific, formal legal opinion to District officials at the request of the District's Solicitor:

> **5.** The School District solicitor expressed concerns about the School District borrowing funds before it was ready to start the underlying capital projects. In particular, the solicitor communicated to Weiss that the School District had not decided which capital projects they were going to undertake, and did not want to be locked into undertaking the renovation project because of the financing. In response, Weiss wrote, on or about May 2, 2000, an opinion letter in which he stated that because "there are capital projects being contemplated for which proceeds will be used should the projects be undertaken," it was his belief that the issuance of the Notes was "totally proper".[45]

The Commission did not refer to that opinion in its release regarding the District. Neither did the Commission tell the market why the District could not rely on that opinion.

Frankly, it is quite difficult to imagine how much more a local government official could do to ask appropriate questions[46] and receive assurances under conditions in which local officials may not have known how to recognize the "materiality" of information.

Once again, as noted, District officials did have a warning[47] about the form of transaction, and appear to have approved and executed documents they did not read, or at

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[45] *In the Matter of Weiss and Shupe*, SEC Admin Proc. No. 3-11462 at Section II.F ¶5 (Order Instituting Proceedings, Apr. 22, 2004).

[46] See, *e.g.*, **QUESTIONS TO ASK BEFORE YOU APPROVE A BOND ISSUE, A POCKET GUIDE FOR ELECTED AND OTHER PUBLIC OFFICIALS**, prepared by the National League of Cities; the National Association of Counties; the National Association of State Auditors, Comptrollers and Treasurers; and the Government Finance Officers Association with input from the Securities and Exchange Commission, recoimmending that issuer officials ask questions of bond professionals.

[47] See the text accompanying n. 21, *supra*.

least did not read closely.[48] The Commission, however, did not cite those facts in its release regarding the District.

The stark inevitable conclusion is that issuer officials simply must demand the time necessary to review carefully all documents they approve and sign.

If they do not do so, or even if they do so but overlook a misstatement or misunderstand representations written for them by bond professionals, issuers and officials likely will remain at risk if something goes wrong in the bond issue.

Action Against Underwriter

Even when issuers may not be permitted to rely on legal counsel or financial professionals, the Commission may proceed against the counsel and financial professionals, as well. In the case of the Neshannock District, the Commission acted against an official of the underwriter and against bond counsel.

The underwriter "was contractually obligated to prepare the Official Statement for the Notes on behalf of the School District.[49] According to the Commission,

> **14.** … The Official Statement prepared by Shupe [the underwriter official] represented that the net proceeds from the sale of the Notes would be used to provide funds for capital improvement projects of the School District. The Official Statement did not accurately describe the use of the Note proceeds, and did not disclose the resulting risk to the Notes' purported tax-exempt status. The Notes were offered and sold by Quaestor [Shupe's firm] to investors at interest rates commensurate with their purported tax-exempt status.
>
> **15.** At all relevant times, Shupe knew or was reckless in not knowing that the Official Statement failed to disclose the true purpose of the offering which was to gain $225,000 in arbitrage profits.
>
> **16.** Moreover, at all relevant times Shupe knew, or was reckless in not knowing, that the School Board had yet to resolve whether to proceed with its primary capital project involving renovations and additions to an existing school building, or which of its smaller capital projects had priority.
>
> **17.** Shortly after the closing on the Notes, the School District, at the suggestion of Shupe, invested the net Note proceeds in a Federal Home Loan Bank obligation maturing within sixty days of the maturity date for the Notes. The School District did not enter into any formal commitment to expend any

[48] See the text accompanying n. 54, *infra*.

[49] *In the Matter of Weiss and Shupe*, SEC Rel. Nos. 33-8459, 34-50235 at ¶14 (Aug. 24, 2004) [as to Andrew Shupe].

> portion of the Note proceeds within six months, nor did it expend any portion of the net Note proceeds on any capital project within three years.[50]

The underwriter official was barred from association with any broker or dealer (with reapplication subject to Commission approval) and was ordered to cease and desist securities law violations.[51]

Action Against Bond Counsel

In the *Neshannock* matter, as noted above, the SEC also brought enforcement proceedings against the bond counsel involved in the District's note transaction.[52] That action went to trial before an Administrative Judge in July 2004 and is awaiting a decision as of this writing.[53]

School District officials had looked to bond counsel for advice and representation of their interests. One District official testified that she was handed the papers to sign and told to sign them, and another testified that he had relied completely upon bond counsel.[54] Conversely to the Neshannock School District's assertions of reliance on bond counsel, however, the District's bond counsel was reported to have asserted, as a defense, reliance upon the District's certification as to the use of note sale proceeds for capital projects.[55]

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[50] *In the Matter of Weiss and Shupe*, SEC Rel. Nos. 33-8459, 34-50235 at ¶¶14-17 (Aug. 24, 2004) [as to Andrew Shupe].

[51] *In the Matter of Weiss and Shupe*, SEC Rel. Nos. 33-8459, 34-50235 (Aug. 24, 2004) [as to Andrew Shupe]; Hume "*SEC Bars Shupe From Markets, But Doesn't Impose Financial Penalties,*" The Bond Buyer Online (Aug. 24, 2004). The Commission's imposition of disgorgement was waived in view of the Respondent's financial condition.

[52] *In the Matter of Weiss and Shupe*, SEC Admin Proc. No. 3-11462 (Order Instituting Proceedings, Apr. 22, 2004); SEC Rel Nos. 33-8412, 34-49596 (Apr. 22, 2004).

[53] Hume, "*SEC Shifts Fraud Focus,*" The Bond Buyer Online (July 13, 2004).

[54] Hume, "*SEC Case: School Officials Say Weiss Didn't Counter Shupe Plan,*" The Bond Buyer Online (July 14, 2004).

[55] See Hume, "*SEC to Fight Weiss, Settle With Shupe Over School Notes*," The Bond Buyer Online (July 6, 2004, stating:

> "The legal conclusion set forth in [bond counsel's] opinion was based upon the school district's written representation that the note proceeds would be used to fund the school district's capital improvement projects," Weiss' attorney David Hickton, a co-founder of the firm Burns, White & Hickton, LLC in Pittsburgh, told the SEC several weeks ago in a written response to the charges.
>
> "In the performance of his duties as bond counsel, Weiss had the right to rely upon, and he reasonably relied upon, the written representations of the school district with respect to its intentions and expectations regarding the use of the note proceeds," Hickton said.

See also Hume, "*Weiss Gets 'Expert' Help,*" The Bond Buyer Online (July 15, 2004).

Advice To Be Rendered by Bond Counsel

Among other things, bond counsel was criticized by the SEC's Division of Enforcement for failing to challenge the underwriter's description to the School Board of the District's ability to utilize three-year notes in order to earn arbitrage profit. The Division also criticized bond counsel for failing to advise the Board of the parameters under federal tax laws of the three-year temporary period.[56]

The Division of Enforcement alleged that bond counsel "caused" the School District's violations.[57]

The allegations raise the question as to the extent to which, in the SEC's view, bond counsel and other legal counsel to issuers have affirmative duties to render explicit advice, and to explain technical legal matters, to issuers.[58]

In the action, the Division alleged the following in the context of bond counsel's consultations with District officials:

> [D]uring the joint representation, Weiss responded to an inquiry from a School Board member, concerning the consequences if the School District did not spend any money on the controversial renovation project. Weiss's response was that so long as the School District "intended" to undertake the project, which he understood it did, then the School District was not actually required to spend the money or to do the project in order to keep the profit. Weiss did not explain that Neshannock had to have objectively reasonable expectations of **(i)** spending substantially all of the Note proceeds within three years, **(ii)** entering into a binding commitment within six months, or **(iii)** proceeding with due diligence to completion.[59]

The SEC did not discuss whether it would assert a duty to advise the issuer if bond counsel had been completely silent regarding the transaction. Nevertheless, it would be difficult for legal or financial professionals to be totally silent in the conduct of a bond transaction.

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[56] Hume, "*SEC Case: School Officials Say Weiss Didn't Counter Shupe Plan*," The Bond Buyer Online (July 14, 2004). See also Hume, "*Weiss Gets 'Expert' Help*," The Bond Buyer Online (July 15, 2004), stating, "SEC trial attorney Christina Rainville asked Weiss why he told Shupe, but not the school board members, that the proposal was wrong and that it would violate tax laws."

[57] *In the Matter of Weiss and Shupe*, SEC Admin Proc. No. 3-11462, at the end of Section II.A, and Section II.G, ¶4 (Order Instituting Proceedings, Apr. 22, 2004); SEC Rel Nos. 33-8412, 34-49596 (Apr. 22, 2004).

[58] See the discussion, at the text accompanying nn. 75-79, *infra*, of similar, but more extensive, arguments advanced by the SEC's Division of Enforcement against a financial advisor.

[59] *In the Matter of Weiss and Shupe*, SEC Admin Proc. No. 3-11462, Section II.F, ¶7 (Order Instituting Proceedings, Apr. 22, 2004); SEC Rel Nos. 33-8412, 34-49596 (Apr. 22, 2004).

Despite such elements of risk for bond counsel and underwriters, it is likely to be cold comfort to issuers that actions may also be brought against other parties, including some upon whom the issuers rely.

Summary

In summary, the *Neshannock School District* action illustrates the following:

- Monetary risks confronting municipal securities issuers in connection with their disclosure documents;
- The absence of a requirement for investor losses in order for an SEC action to be brought;
- The importance of heeding SEC precedents;
- Use of closing documents in disclosure actions;
- The importance of issuer officials reviewing closely all documents executed by the officials;
- The SEC's views requiring:
    - Disclosure of uncertain information, and
    - An issuer's careful review of official statement disclosures and closing documents executed by issuer officials, even when the documents are prepared by legal counsel and involve complex and arcane tax or other subject areas;
- Limitations on an issuer's ability to rely on the advice of legal and financial municipal bond professionals as to whether information should be disclosed (at least in the absence of formal written opinions specifically on the subject and perhaps not even then);
- The insufficiency of asking specific questions and seeking assurances from professionals, if issuer officials have knowledge or notice of undisclosed material information (even if the issuers do not recognize that the information is "material" to investors);
- Governmental issuers and officials can be subject to remedies, even when professionals participating in bond issues are alleged to have committed their own securities law violations; and
- Assertions by the SEC's Division of Enforcement as to advice required to be rendered to issuers by municipal finance professionals.

Dauphin County General Authority

Background

A recent SEC action against the Dauphin County, Pennsylvania, General Authority,[60] related to an Authority bond issue to finance acquisition of an office building. The Authority intended to continue the building's practice of leasing space principally to Commonwealth agencies and other governmental agencies. According to the SEC, adding credence to Dr. Kittredge's survey results, "the Authority members read little, if any, of the Preliminary Official Statement prior to their vote" approving the document and authorizing its distribution.[61]

In this instance, the Commission gives the reader of the release specific information as to how the issuer's officials deliberately failed to take action necessary to consider whether information should be disclosed. Under the *Dauphin County Authority* release, the SEC charged the Authority only with violations of Sections 17(a)(2) and (3) of the Securities Act of 1933, issuing a cease and desist order against the Authority. In doing so, "the Commission considered remedial acts promptly undertaken by Respondent and cooperation afforded the Commission staff."[62]

The SEC asserted, however, that "The Authority was responsible for the contents of the Official Statement."[63]

Official Statement Preparation by Underwriter Counsel

The SEC also alleged in its action, discussed below, against the Authority's financial advisor and underwriter, that counsel to the underwriter had drafted the Authority's Official Statement.[64] Therefore, the Authority's disclosure document was prepared by a legal counsel who did not have a contractual relationship with the Authority.

That describes a practice quite disadvantageous to issuers, even though not uncommon in municipal securities offerings.[65] Issuers lose important protections when

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[60] *In the Matter of Dauphin County General Authority,* SEC Rel. No. 33-8415 (Apr. 26, 2004).

[61] *Id.* at ¶5.

[62] *Id.* at the end of Section III.

[63] *Id.* at ¶4.

[64] *In the Matter of Public Finance Consultants, Inc., et al.,* Admin. Proc. 3-11465 at Section D, ¶3 (Order Instituting Proceedings, (Apr. 26, 2004); SEC Rel. Nos. 33-8414, 34-49619 (Apr. 26, 2004).

[65] The practice also is disadvantageous to underwriters because the underwriters (or their counsel acting for them) write the issuer's disclosure documents for the issuers, guiding the process of selection of the information to be included and actually writing the disclosure information in a direct manner. Underwriters thereby often assume broader duties extending beyond purely reviewing in a professional manner the issuers' key representations in the official statements. See SEC Rule 15c2-12, 17 C.F.R. §240.15c2-12, requiring underwriter "review" of an official statement deemed final by an issuer, and the

they rely, in the preparation of their disclosure documents (for which the issuers have an asserted primary responsibility and ultimate liability), upon underwriter counsel. Underwriter counsel generally have no contractual or attorney-client relationship with the issuers, do not address opinions to issuers, and exclude important areas of information from the scope of their opinions.

Similarly, issuers lose important protections when they rely, as in the case of the Neshannock School District discussed above, in their disclosure document preparation upon the underwriters themselves. Underwriters commonly consider themselves to be principals dealing with issuers solely at arms'-length. There are significant differences in interests between issuers, who are asserted by the SEC to be "primarily responsible" and "ultimately liable" for the disclosure documents, and underwriters, who are responsible to review in a professional manner the issuers' "key"[66] representations in those documents,[67] but also who are paid only when they sell bonds.

Authority's Investigation

In the case of the Dauphin County Authority, the bonds were payable from tenant lease rentals and parking rentals in the acquired building. Much of the space (90%) was occupied by Commonwealth of Pennsylvania departments, including the Department of Transportation ("DOT") (80%, providing 60% of revenues). The DOT's lease, however, was to run for only three more years, by which time the DOT was to move to a new building to be constructed for it. The Authority was aware of the Commonwealth's plans for the DOT's move.

Indeed, the DOT did move, resulting in a bond default when the Commonwealth failed to continue to lease the space. Despite a tight real estate market (which was mentioned in an appraisal included in the Authority's Official Statement),[68] tax laws restricted significantly the Authority's ability to lease space to private tenants.[69]

SEC's interpretation of the nature of that review contained in SEC Rel. No. 34-26100, 53 F.R. 37778 (Sept 28, 1988), and SEC Rel. No. 34-26985, 54 F.R. 28799 (July 10, 1989).

Instead, the underwriters, through their counsel, become inextricably intertwined in the process of actual document preparation, generally a far more active process.

[66] To date, neither the Commission nor any court has defined for market participants the meaning of the term "key."

[67] SEC Rule 15c2-12, 17 C.F.R. §240.15c2-12; SEC Rel. No. 34-26100, 53 F.R. 37778 (Sept 28, 1988), and SEC Rel. No. 34-26985, 54 F.R. 28799 (July 10, 1989).

[68] In the litigation against the Authority's financial advisor and the bond underwriter, the SEC's Division of Enforcement argued that the local real estate market was artificially tight because the building previously occupied by the DOT had burned, and the DOT occupied space in the building acquired by the Authority only pending construction of the new building. See *In the Matter of Public Finance Consultants, Inc., et al.,* Admin. Proc. 3-11465 at Section E, ¶11 (Order Instituting Proceedings, (Apr. 26, 2004).

[69] The SEC's Division of Enforcement argued that the tax law restrictions confined the Authority's flexibility to lease space in the building, after the DOT's move, limiting the universe of potential tenants to Commonwealth agencies and other local governments.

Prior to the bond issue, "various Authority Board members and professional advisors expressed concerns" about what would happen after the DOT moved. The Authority's financial advisor, Executive Director and bond counsel investigated, meeting with a responsible Commonwealth official, heading the Commonwealth's Department of General Services, which was responsible for Commonwealth agency leasing activities and building construction. The official declined to commit to future leases, but remained open to the possibility. The attendees at the meeting all testified in depositions that they believed the Commonwealth official had outlined a potential program for continued use of the DOT space after DOT moved.

Thus, the Authority's Executive Director, as an attendee at the meeting, was aware of the Commonwealth's posture. Further, the DOT's planned move was discussed, as reflected in minutes, with the Authority's Board.

Disclosure Issues

The Authority's Official Statement disclosed risks of the building's short-term leases. Such disclosure appeared in several forms emphasized by capital letters and bold fonts at several places in the official statement. One such caution read:

> **THE OFFICE LEASES ARE SCHEDULED TO EXPIRE PRIOR TO THE MATURITY OF THE 1998 BONDS; THERE IS NO COMMITMENT, REQUIREMENT OR GUARANTEE THAT THE COMMONWEALTH WILL RENEW OR EXTEND ANY OF THE OFFICE LEASES.**[70]

That statement, while literally accurate, was considered by the SEC to be misleadingly general and imprecise, in that the statement "impl[ied] that there was at least a possibility that the State would renew or extend the leases."[71] The statement failed to disclose the specific information that there were definite plans for DOT to move in three years, vacating a large proportion of the building under conditions in which the universe of potential tenants was restricted.

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[70] Official Statement dated July 17, 1998, at 13. [Emphasis in original.] Similar capitalized cautions appear in the Authority's Official Statement's at the cover page and at p. 12. An appendix disclosed the term of and amount of space subject to each lease.

Although not noted in the Commission's Order Instituting Proceedings, bond counsel rendered an opinion to the underwriter as to the fairness of the "matters" described in the Official Statement section encompassing one of the statements as to the short-term nature of the leases.

[71] *In the Matter of Dauphin County General Authority*, SEC Rel. No. 33-8415 at ¶14 (Apr. 26, 2004).

In that regard, an SEC attorney was paraphrased as emphasizing that:

> Municipal bond issuers and other transaction participants cannot just disclose to investors in bond offering documents that something might happen that will threaten the bonds when they know that it definitely will happen … .[72]

With respect to the cautionary language in the Authority's Official Statement, the attorney stated:

> General warnings are not sufficient … . You can't expect investors to do the issuer's and investment banker's jobs.[73]

Assertions that the planned move of the DOT was well-known locally and reported in the local press did not excuse a failure to make disclosure to investors, according to the SEC's attorney,

> … it is not the obligation of investors to ferret out the information. It's the obligation of the underwriter and the issuer to collect that information and present it to the investors.[74]

Advice To be Rendered by Financial Advisor

As noted above, the SEC also commenced an action against the Authority's financial advisor and the underwriter.[75] In that action, the SEC alleged that the Authority relied upon advice of the Authority's financial advisor regarding the structure of the transaction and content of the Official Statement, and that the financial advisor had a fiduciary relationship to the Authority. The Commission alleged that the financial advisor caused the Authority's violations through assurances rendered to Authority officials and failures to warn about disclosure issues and risks of the transaction[76]

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[72] Hume, "*SEC Enforcement Case Shows General Disclosure Not Enough*," The Bond Buyer Online (Apr. 27, 2004), paraphrasing comments of Mark Zehner.

[73] *Id.*

[74] *Id.*

[75] *In the Matter of Public Finance Consultants, Inc., et al.,* Admin. Proc. 3-11465 (Order Instituting Proceedings, (Apr. 26, 2004); SEC Rel. Nos. 33-8414, 34-49619 (Apr. 26, 2004).

The trial was held before an Administrative Law Judge in August 2004. Hume, "*Merrill Analyst Faults Disclosure in SEC's Bond Fraud Case*," The Bond Buyer Online (Aug. 17, 2004); Hume, "*SEC Case: Underwriter's Counsel Unaware of Moving Plans*," The Bond Buyer Online (Aug. 18, 2004); Hume, "*Investors Line Up With SEC Against Dealer, FA in Disclosure Case*," The Bond Buyer Online (Aug. 19, 2004). As of this writing, the Judge's decision is pending.

[76] *In the Matter of Public Finance Consultants, Inc., et al.,* Admin. Proc. 3-11465 at Section E, ¶9 (Order Instituting Proceedings, (Apr. 26, 2004).

The Commission's Division of Enforcement argued, through its expert, that the financial advisor should have advised the Authority's officials as to:

- Special risks in the transaction of selling nonrated bonds;
- The Authority's responsibility for the accuracy and completeness of the Official Statement;
- The Authority's responsibilities to assure full disclosure regarding facts and circumstances that could affect the risks of the Bonds;
- The Authority's responsibilities to assure full disclosure regarding the nature of the credit;
- The Authority and its Board members' inability simply to rely on experts and professionals as to disclosure decisions;
- The Authority's obligation to disclose specific information in the Official Statement, such as facts and circumstances that could affect the risk that the building might not remain fully leased;
- Liability could be created for the Authority without such disclosures; and
- Important protections would be available to the Authority as a result of such disclosures.

As stated in part by the SEC's expert:

> **36.** [The financial advisor] *failed to disclose to the Authority* that, in the issuance and sale of the Bonds, *the Authority as issuer was responsible* for the accuracy and completeness of the offering document and that *the Authority had responsibilities as issuer to investors to ensure full disclosure* on the nature of the credit being sold, which was a limited recourse, highly specialized real estate venture undertaken by the Authority for, among other purposes, the production of revenue for the Authority. [The financial advisor] *failed to advise* the Authority of the special risks of selling unrated bonds and *that the Authority and its members could not avoid liability under the securities laws or other risks simply by relying on experts and professionals*.
>
> **37.** The records of the Authority and [the financial advisor's] testimony indicated that while he informed the Authority of both the expected termination of the PENNDOT Lease and the absence of any specific assurance or commitment regarding a "swing space program" by the Commonwealth that might keep the Project substantially full, [the financial advisor] *did not advise the Authority members that the Authority as issuer of the Bonds was obligated to disclose facts and circumstances that could affect the risk* that the Project might not remain fully leased and that failure to make such disclosure *could create liability for the Authority*. And he *did not advise the Authority* that disclosure on both the PENNDOT Lease and the vagueness of the supposed swing space program could be important to investors and that therefore disclosure on these issues *would provide important protection to the Authority as issuer of the Bonds*. Indeed, subsequent to the issuance of the Bonds, in response to an inquiry

> by an Authority member, he indicated that bondholders and not the Authority had assumed all the risk that the Project might not remain fully leased.
>
> * * *
>
> **62.** In *failing to explain* to the Authority's members *the Authority's obligations* in connection with the sale of the Bonds and *the need to disclose* the information on the PENNDOT Leases and the uncertainties of the swing space program, [the financial advisor] *failed in his duty as the Authority's financial advisor and as a public finance professional to whom the Authority looked for advice and explanation on such matters*. [The financial advisor's] later assertion to Authority members that the bondholders, rather than the Authority and its members, were taking the risk that the Project would not be filled with qualifying leases of the Commonwealth over the life of the Bonds *provided false and misleading comfort* to Authority members that the failure to disclose both these matters was not a matter of concern of the Authority.
>
> **63.** [The financial advisor] *failed in his duty to the Authority in not providing clear disclosure to its members of the risks to the Authority and its members of selling unrated securities in a public offering and of their responsibilities in promoting accurate and complete disclosure. In particular, he took no steps to correct their erroneous belief that they could rely completely on financial advisors, counsel, and other experts in such matters.*[77]

The Division's expert also opined that the underwriter had a duty to the Authority "to take steps to promote accurate and complete disclosure in the Official Statement" and the underwriter's failure to do so "constituted a gross failure of professional responsibility to … the Authority."[78]

Given the fiduciary nature of lawyer-client relationships, and the legal elements of advice that the Division argued should have been rendered, the foregoing arguments also should be of substantial interest to lawyers representing issuers in municipal securities transactions—bond counsel, disclosure counsel, City and County Attorneys, outside local issuer counsel, and other lawyers representing issuers.[79]

Summary

In summary, the *Dauphin County Authority* action illustrates the following:

- The importance of issuer officials' reviews of official statements;
- How even literally accurate statements may be considered to be misleading due to the omission of other information;

[77] Report and Direct Testimony of Robert Dean Pope dated July 19, 2004, at 18-20, 57-28.

[78] *Id.* at 30.

[79] See also the discussion relating to bond counsel to the Neshannock Township School District, *supra*, at text accompanying nn. 56-59.

- The insufficiency of investigations of information when issuer officials know material information that is not disclosed (even if issuer officials do not recognize the "materiality" of that information);
- The importance of disclosure of information as to intentions for future action (*e.g.*, in the *Dauphin County Authority* action, the intentions for DOT to move in a few years to a new building to be constructed);
- The importance of specific risk disclosures despite explicit cautions to investors as to transactional risks;
- The importance of using official statements to convey information to investors despite public availability of the information from other sources;
- Limitations on an issuer's ability to rely on the advice of legal and financial municipal bond professionals as to whether information should be disclosed (at least in the absence of formal written opinions specifically on the subject and perhaps not even then);
- How governmental issuers and officials can be subject to remedies, even when professionals participating in bond issues are alleged to have committed their own securities law violations; and
- Assertions by the SEC's Division of Enforcement as to advice required to be rendered to issuers by municipal finance professionals.

Further, in a practical sense, the action calls into question the practice of issuers' looking to underwriters or underwriter counsel to prepare issuer disclosure documents, as opposed to a counsel or party in a contractual relationship with the issuers.

The *Dauphin County Authority* and the *Neshannock School District* actions lay a foundation for the Commission to assert direct duties of municipal bond professionals, both lawyers and financial professionals, to render explicit advice to issuer officials regarding the issuers' disclosure responsibilities and transactional risks. If that line of argument is pursued, as appears likely, it will impact the world of municipal finance significantly.

While issuers would benefit from greater levels of advice and enhanced professional service and loyalty, some issuers may well receive advice they do not want to receive.[80] The receipt of the advice will place direct responsibilities on issuers and

[80] An illustration of a municipal official seeking to avoid evidence of receipt of professional advice appears in *In the Matter of the City of Miami*, SEC Rel. No. 33-8213, 34-47552 at text accompanying nn. 10-12 (Opinion of the Commission, March 21, 2003), as follows:

> Miami retained two financial advisers: Howard Gary & Company ("HG & Co.") and Raymond James & Associates, Inc., ("Raymond James"). Kishor Parekh ("K. Parekh"), a partner of HG & Co. and D. Parekh's brother, was the HG & Co. primary contact with Miami. By letter dated September 30, 1994, addressed to Garcia, then Director of Finance, the financial advisers warned Miami that "the City's general credit rating will experience a downgrade in the near future." The letter highlighted Miami's "low level of unreserved

their officials to respond with additional care and disclosure. Issuer officials will be required to take time to review documentation carefully, even if they do not easily understand the documents.

At least in riskier financings, transactions will be slowed, and costs will rise. That may be viewed as a positive development overall.

Clearly, for issuers in such transactions, the lowest cost professional service providers may no longer be the preferable ones to employ. Issuers also should avoid selection of and reliance upon professional teams and experts advocated by private third parties interested in the completion of municipal bond transactions, focusing instead upon the issuers' needs for independent advice.

For issuers' protection, it may (and probably should) become preferable to employ municipal bond professionals who spend additional time and care, even if at greater costs. As the SEC stated in 1989:

> Because they are ultimately liable for the content of their disclosure, issuers should insist that any persons retained to assist in the preparation of their disclosure documents have a professional understanding of the disclosure requirements under the federal securities laws.[81]

> General Fund balances, the City's reliance on non-recurring revenue initiatives, asset sales, basic infrastructure maintenance needs, as well as the City's overall revenue inflexibility." The financial advisers believed that Miami's fiscal health was approaching a "precarious situation."
>
> According to K. Parekh, Garcia chastised him for sending the letter and instructed that in the future any similar concerns should be raised only orally.

The Commission further noted in its n. 11:

> K. Parekh testified that the financial advisers put their concerns in writing to ensure that Miami understood that the City's "deteriorating fiscal condition" would continue to decline, and was "extremely important" to address. K. Parekh further testified that in deviation from their usual practice, the financial advisers captioned the letter to Miami, "PRIVILEGED AND CONFIDENTIAL," in order to stress the sensitivity of the issues raised.

In *Allstate Insurance Company v. Mesirow Financial, Inc., Peacock, Hislop, Inc. et al.*, No. CIV 97-213-PHX-TSZ (lead), No. CIV 98-1315 PHX SMM, No. CIV 98-131 PHX RGS (Consolidated) (D. AZ), a jury imposed several million dollars in liabilities upon the financial advisor to a small newly-created sewer district. Counsel to the district had argued in relation to a cross-claim, in litigation filed against the district and its officials by an investor, that while the financial advisor had identified to district officials certain concerns regarding the financing structure proposed by the underwriter, and had resigned from the transaction, the financial advisor had failed to identify a range of other important concerns in explicit terms or in writing.

[81] SEC Rel. No. 34-26985, 54 F.R. 28799, 28811 n.84 (July 10, 1989).

Massachusetts Turnpike Authority

Disclosure in the context of ambiguous and uncertain information was a key issue in an SEC action against the Massachusetts Turnpike Authority ("MTA") and the Authority's Chairman.[82] In that action, the SEC criticized the Authority's disclosures relating to rising costs on the "Big Dig" highway, bridge and tunnel project in Boston.

The MTA provided information in bond offering documents as to the project's costs, but avoided disclosure of cost-overrun information, in part because the information was deemed to be "speculative" in the absence of quantification and confirmation, and in part due to a fear that disclosure might lead to a "self-fulfilling prophecy" of rising costs. The Chairman first ordered a thorough "bottom-up" internal review of costs, and did not disclose the increases pending completion of the detailed and lengthy review.

The Commission described that process, as follows:

> Given the scope of the Project, costs were a concern from its inception. In an attempt to contain costs and achieve the Project's budget, the Project staff continually reviewed cost trends and pressures. Bechtel/Parsons regularly prepared cost estimates, which were reviewed and then used by the Turnpike Authority to manage the Project. Throughout this period, Kerasiotes told the Project staff that budget management was a "zero sum game," meaning that, for every cost increase, the Project staff must find a corresponding cost reduction or source of revenue. *Kerasiotes was reluctant to approve increases in the Project budget estimates* in part because he believed that public disclosure of an increase before it was absolutely certain that such an increase was unavoidable would make such an increase *a self-fulfilling prophecy, thereby leading to Project cost increases that might otherwise have been prevented*. Although this approach was an effort by Respondents to attempt to hold Project costs down, Respondents were negligent in failing to disclose cost increases in 1999, given how far the Project had progressed.[83]

Despite the Chairman's "effort to control costs," the SEC considered the MTA, and the Chairman personally, to have committed securities law violations for failure to disclose known information as to the existence of cost overruns that were substantial, albeit uncertain as to amount. The Commission alleged that the respondents violated Section 17(a) of the Securities Act of 1933.[84]

It is worth observing that many of the MTA's bonds were backed by the Commonwealth's general credit, and some were insured.[85] One bond issue was of

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[82] *In the Matter of The Massachusetts Turnpike Authority and James J. Kerasiotes*, SEC Rel. No. 33-8260 (July 31, 2003).

[83] *Id.* at Section III.D.1.

[84] *Id.* at the end of Section III.E.

[85] *Id.* at Sections III.D.3 and D.5. Actually, the latter bond issue was of bonds issued by the Massachusetts Bay Transportation Authority, for which the MTA provided information.

Commonwealth of Massachusetts general obligation bonds, for which the MTA provided information.[86] In other words, the presence of insured bonds does not grant assurance that the SEC will not bring an enforcement action.[87] Further, while insured bonds may protect against litigation brought by investors, the bond insurance companies, with their sophistication and extensive assets, may prove to be even more difficult plaintiffs.[88]

In particular, in the MTA release, the Commission tells readers why the information as to cost overruns was "material" to an investor, despite the presence of bond insurance or the state guarantee:

> Reasonable investors would have considered Project cost increases in excess of $1 billion to be an important factor in the investment decision-making process and would have viewed such information as significantly altering the total mix of information available. In addition to being a substantial amount in absolute terms, the cost increases equaled approximately 3% of the total revenues of the

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[86] *Id.* at Section III.D.4.

[87] In outlining factors that determine the extent of investigations required by underwriters of issuer representations, after first indicating that the presence of bond insurance could affect the level of an underwriter's investigation, the Commission reversed course, based upon communications received from bond insurers to the effect that bonds insured by the same insurers trade differently (suggesting that underlying issuer information plays a role) and from investors to the effect that they consider underlying issuer information in making investment decisions.

The Commission opined, as follows:

> In the Commission's view, the presence of credit enhancements generally would not be a substitute for material disclosure concerning the primary obligor on municipal bonds. Several commentators, including analysts, investors, and insurers, have indicated that even in credit enhanced offerings they rely upon disclosure concerning the primary obligor. In credit enhanced offerings, there is event risk, including default or [sic] the primary obligor, that may impair the value of the municipal bonds. … [T]he Commission wishes to emphasize that the presence of credit enhancement does not foreclose the need for a reasonable investigation of the accuracy and completeness of key representations concerning the primary obligor. Accordingly, the Interpretation is modified to the extent that it suggests the presence or absence of credit enhancements generally would be a significant factor in assessing the reasonableness of the underwriter's investigation. SEC Rel. No. 34-26985, 54 F.R. 28799, 28812 (July 10, 1989). [Footnotes omitted.]

Interestingly, the SEC's statement that "the presence of credit enhancements generally would not be a substitute for material disclosure concerning the primary obligor" does not state that exactly the same information necessarily would be "material" in an insured issue as in an uninsured issue for the same issuer.

[88] Underwriters have been sued by bond insurers in at least two recent actions: *Financial Security Assurance Inc. v. Stephens, Inc., et al*., Civ. No. 1 00-CV-3181 (N.D. GA); and *In re River Park Square Project Bond Litigation*, Case No. CS-01-0127-EFS (E.D. WA) (secondary market bond insurance).

In one action, the Court ruled broadly in favor of the underwriter on summary judgment under both the federal securities laws and state law. *Financial Security Assurance Inc. v. Stephens, Inc., et al.*, Civ. No. 1 00-CV-3181 (Orders dated Sept. 19, 2001, and Aug. 23, 2004, N.D. GA). As of this writing, this author has received no information as to whether the Orders will be appealed.

The second action, relating to and settled with the City of Spokane (and including the City and others as defendants), is discussed, *infra*, at text accompanying nn. 103, *et seq*.

> Commonwealth estimated for fiscal year 2000 and 2001 (when the majority of the cost increases would be incurred) and 9% of the total Commonwealth debt load as of January 1, 1999, and exceeded the amount of the Commonwealth's rainy day fund. Reasonable investors were entitled to know about cost increases of this magnitude that would have to be met by the Commonwealth and/or the Turnpike Authority so the investors themselves could evaluate the financial condition of the Turnpike Authority and/or Commonwealth and analyze fully the bond offerings. …[89]

In the Commission's action against the City of Miami, the City's bonds also were insured. Administrative Law Judge Brenda Murray discussed this consideration, as follows:

> The three bond issues were insured so that bondholders had an unconditional guaranty to full payment of principal and interest. … The investors involved in the offerings had a high comfort level because the bonds were insured and assumed that the City's finances had received careful scrutiny. … It appears that the City limited its disclosure for the same reasons. … According to Mr. Odio [the City Manager],
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> > [M]ost people don't read [the Official Statement], nobody reads this. They go by what the raters, that is Moody's, Standard & Poor's, saying that these bonds are safe to buy. By rating them AAA, they're a very good buy. Therefore, they wouldn't go reading this. Nobody does.[90]

Judge Murray concluded:

> An objective consideration of the evidence indicates that a cease and desist order is necessary to protect investors. The violations involved conduct by top City officials intended to mislead the public about material information concerning the status of the City's finances in the offer and sale of bonds totaling approximately $116.5 million. The illegal actions were repeated on three occasions over a six-month period. The City's attitude that disclosure was not important because no one reads the Official Statement when the bonds are insured, and that regardless of what the 1994 Financial Statements showed, "people in the business" understood what was going on does not engender confidence in the City's future conduct. [91]

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[89] *In the Matter of The Massachusetts Turnpike Authority and James J. Kerasiotes*, SEC Rel. No. 33-8260 at Section E (July 31, 2003).

[90] *In the Matter of the City of Miami*, SEC Initial Decision Rel. No. 185 at Section II (text accompanying n. 27) (June 22, 2001), *aff'd*. by the Commission, SEC Rel. No. 33-8213, 34-47552 (March 21, 2003).

In its Affirmance, the Commission stated, at text accompanying n. 39 in the Commission's opinion:

> Bond insurance did not give Miami license to misrepresent its financial condition or withhold material information from the marketplace. [Note omitted.]

[91] *In the Matter of the City of Miami*, SEC Initial Decision Rel. No. 185 at the end of Section IV (June 22, 2001), *aff'd*. by the Commission, SEC Rel. No. 33-8213, 34-47552 (March 21, 2003).

Thus, in summary, the Commission's action against the MTA and its Chairman illustrate the following:

- State agencies are not immune from SEC enforcement actions;
- Issuer officials are at risk personally;
- The absence of a requirement for investor losses in order for the SEC to bring enforcement actions;
- The presence of risks to issuers (and officials), even when bonds are insured; and
- The Commission's views that:
    - Material information must be disclosed even if uncertain and unquantified, and
    - Disclosure cannot await investigations—in some cases, the better solution may be to delay bond issuance.

Holmes Harbor Sewer District

An issuer and its governing board members personally incurred monetary liabilities in private litigation solely under state securities laws in the *Holmes Harbor Sewer District* litigation.[92] The issuing District and its Commissioners paid several hundred thousand dollars to settle claims.[93] The District had employed bond professionals recommended by the private developer.

The litigation illustrates the important point that issuers and officials need not be concerned only with federal antifraud laws—negligence concepts in state securities law and common law, often with longer statutes of limitation, can be potent tools for investors.

The *Holmes Harbor* litigation proceeded solely under the law of the State of Washington. Nevertheless, there is a realistic potential, and indeed likelihood, for securities sales to be made to mutual funds, or individual investors, physically situated in multiple states. Issuers could be confronted with application of a variety of laws, with varying levels of responsibilities and varying statutes of limitation.[94]

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[92] *Trimble, et al. v. Holmes Harbor Sewer District, et al.*, Class Action No. 01-2-00751-8 (Third Amended Complaint dated Sept. 2002, Super. Ct. of Island County, WA).

[93] *Trimble, et al. v. Holmes Harbor Sewer District, et al.*, Class Action No. 01-2-00751-8 (Settlement Agreement dated Nov. 2003, at 3, 8, Super. Ct. of Island County, WA).

[94] See *Nuveen Premium Income Municipal Fund 4, Inc., et al. v. Morgan Keegan & Co., Inc., et al.*, Case No. CIV-00-935-HE (Order dated March 8, 2002, at 2-3, W.D. OK), citing, *inter alia*, *Lintz v. Carey Manor Ltd.*, 613 F.Supp. 543, 550 (W.D. VA 1985) (application of more than one state's law to a single transaction was not prohibited by conflicts of law principles); and *Simms Invest. Co. v. E.F. Hutton & Co.*, 699 F.Supp. 543, 545 (M.D. NC 1988).

The *Holmes Harbor* case, which is still pending against dealer firms[95] participating in the distribution of the bonds and the bond trustee,[96] involves yet another land-based financing (specifically assessment-backed bonds in Washington State). The land-based sector is far and away the most frequently represented sector in the universe of municipal bond issue types upon which the SEC has focused. Again, the District's official statement was prepared with the assistance of underwriter counsel, but underwriter counsel, who did not render an underwriter counsel opinion,[97] was exonerated from all liability by the Court.[98]

In *Holmes Harbor*, the District and its officials had warning. State officials had raised objections to, and questioned authority for, the District's issuance of bonds to finance development of a private office building located outside the District's boundaries. The District's Commissioners then asked questions and received assurances from bond counsel and co-bond counsel as to the legality of the bonds. As to both bond counsel and co-bond counsel, the trial Court ruled on summary judgment "that their opinions were erroneous, they violated the standard of care, and they are liable."[99]

The District's official statement included an appraisal, which had been prepared for another lender, included an extraordinary assumption that did not conform to the facts and circumstances of the bond transaction, and was used without the consent of the appraiser.[100]

An SEC enforcement action is pending against the project developer, developer officials, developer counsel, bond counsel and others.[101] An official of the developer recently was reported to have pleaded guilty to more than 30 criminal counts of conspiracy, securities fraud, wire fraud and money laundering, and his attorney, a

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[95] *Trimble, et al. v. Holmes Harbor Sewer District, et al*., Class Action No. 01-2-00751-8 (Court's Memorandum Decision dated July 11, 2002, Super. Ct. of Island County, WA).

[96] *Trimble, et al. v. Holmes Harbor Sewer District, et al*., Cause No. 01-2-00751-8 (Verbatim Report of Court's Ruling, May 22, 2003) (Super. Ct. of Island County, WA); motion for discretionary review denied, No. 52586-T-1 (Ruling Sept. 3, 2003, Ct. App., Div'n. One, WA).

[97] Instead, bond counsel rendered a disclosure opinion acting as disclosure counsel to the issuer.

[98] *Trimble, et al. v. Holmes Harbor Sewer District, et al*., Class Action Nos. 01-2-00751-8 and 02-2-00223-9 (Verbatim Report of Court's Ruling, Apr. 24, 2003, Super. Ct. of Island County, WA), granting motions to dismiss cross-claims against underwriter counsel filed by bond counsel and a dealer that distributed a substantial proportion of the bonds.

[99] *Trimble, et al. v. Holmes Harbor Sewer District, et al*., Class Action Nos. 01-2-00751-8 and 02-2-00223-9 (Verbatim Report of Court's Ruling, Feb. 24, 2003, at 33, Super. Ct. of Island County, WA). The ruling is on appeal.

[100] *Trimble, et al. v. Holmes Harbor Sewer District, et al*., Class Action Nos. 01-2-00751-8 and 02-2-00223-9 (Verbatim Report of Court's Ruling, March 31, 2003, at 4-9, 14-19, 21-23, Super. Ct. of Island County, WA).

The extraordinary assumption was to the effect that the building would be leased by a "AAA" rated tenant. The actual tenant differed significantly in terms of its credit standing.

[101] *SEC v. Martin, et al*., SEC Lit. Rel. No. 18315 (Aug. 28, 2003).

mortgage banker, another attorney and the District's engineer all also are reported to have pleaded guilty to criminal charges.[102] Those proceedings, however, are of little monetary comfort to the issuer and its officials.

In summary, the *Holmes Harbor* action illustrates the following:

- How issuers can be subject to actual monetary remedies for disclosure violations asserted in securities litigation brought solely under state securities law and common law;
- How issuer officials can be subject to actual monetary remedies for disclosure violations asserted in securities litigation brought solely under state securities law and common law;
- Inadvisability of employment of experts or professionals recommended by private third parties interested in completion of bond issues;
- The importance of precedent (in this instance, regarding reliance upon expert reports and making disclosure in land-based financings);
- How governmental issuers and officials can be subject to remedies, even when private parties and professionals participating in bond issues are alleged to have committed their own securities law violations and even criminal actions;
- Limitations on the value of investigations of information when serious warnings are present;
- Limitations on an issuer's ability to rely on the advice of legal and financial municipal bond professionals as to whether information should be disclosed (even when formal written opinions specifically on the subject are received, if warning signs are present); and
- Limitations on an issuer's ability to rely on a professional appraisal (or another expert report), when the issuer or its officials have knowledge conflicting with assumptions or methodology in the appraisal (or other report), when the appraiser (or expert) has not opined as to the reasonableness of the appraiser's (or expert's) assumptions, or when the appraisal (or other report) is used without the consent of the expert.

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[102] Saskal, "*Holmes Harbor Developer Pleads Guilty to Criminal Charges*," The Bond Buyer Online (July 30, 2004); Kelman, "*Holmes Harbor Bond Fraud Attorney Pleads Guilty to Criminal Charges*," The Bond Buyer Online (Aug. 20, 2004); *U.S. v. Martin, et al*., No. CR03-0370RSL (Superseding Indictment dated Feb. 12, 2004, W.D. WA); *U.S. v. White*, No. CR03-0370RSL (Plea Agreement dated March 16, 2004, W.D. WA); *U.S. v. Smith*, No. CR03-0370RSL (Plea Agreement dated Apr. 28, 2004, W.D. WA); *U.S. v. Killingsworth*, No. CR 04-124P (Information dated March 23, 2004, W.D. WA); *U.S. v. Killingsworth*, No. CR 04-124P (Plea Agreement dated March 24, 2004, W.D. WA); *U.S. v. Martin*, No. CR03-0370RSL (Plea Agreement dated July 29, 2004, W.D. WA); *U.S. v. Tezak*, No. CR03-0370RSL (Plea Agreement, W.D. WA).

Certain warning signs are identified in the *Holmes Harbor* litigation with respect to reliance on expert reports:

- Issuers and officials should review expert reports carefully as to the reasonableness of the assumptions and methodology upon which the reports are based;
- The expert's professional opinion should be received as to the reasonableness of the assumptions in the context of the facts and circumstances of the bond issue; and
- Written consent of the expert should be received for use of the report in an official statement (at times, the act of seeking such a consent may lead to changes in the reports, or may lead to information suggesting that reliance should not be placed upon the report).

City of Spokane

Private investors and a bond insurer of bonds in the secondary market brought federal and state securities law litigation against the issuer, the City of Spokane, the underwriter, the developer, law firms, a financial analyst, and other defendants relating to revenue bonds for parking facilities benefiting a private shopping mall developer in the City of Spokane.[103] The City had looked to the parking facilities as an important element of expansion and enhancement of the downtown mall—a "public private partnership." Again, the issuer's official statement was prepared by underwriter counsel.

The City also had believed that the mall's enhancements would lead to increased property values in the downtown area and that associated increased property and sales tax collections would benefit the entire City.

In order to promote those benefits, and given assurances the City received as to the parking garage's feasibility, Spokane agreed to make low interest loans to the project, but only if necessary, to pay the garage's operational costs. Based upon an expert report and advice of a variety of parties, Spokane expected the garage's revenues to pay for the operational costs and bond debt service. The City asserted reliance on various experts, legal and financial professionals, and the project developer.

When the loans became necessary, however, and when the garage's feasibility became questionable, Spokane balked. Instead, Spokane deposited the funds into escrow until the City's obligations could be determined judicially. After the private investors and the bond insurer brought suit, the litigation lasted years. The litigation is still pending in terms of City claims against other parties.

[103] The actual bond issuer was a nonprofit corporation organized to act "on behalf of" a City agency. The shopping mall's developer, however, exercised considerable influence over that actual issuer, for example, influencing the selection of Board members and certain decisions made by the Board, such as selection of the underwriter, activities conducted by the underwriter, and the underwriter's fee.

The City experienced significant liabilities. The City agreed eventually, partially in consideration of an assignment of plaintiffs' claims against other offering participants, to pay from City funds all of the outstanding bond principal and unpaid accrued interest.[104] For the payment (and to pay IRS penalties), the City reportedly intends to issue up to $39 million in new bonds backed by the City's credit.

Reliance on professionals and the existence of a study, titled "Financial Feasibility Analysis," were not sufficient to protect the City. The Financial Feasibility Analysis was not prepared by an independent expert. The firm had worked previously for the downtown mall's developer and was contemplating additional work. A principal author of the Analysis later described it as only a "financial analysis," disavowing the feasibility aspects of the Analysis' title.

Although according to that principal author, the Analysis assumed the existence of a parking validation program that removed economics from parkers' consideration, the Analysis did not:

- Reach a judgment on the reasonableness of the assumptions upon which the Analysis was based;
- Evaluate a number of important considerations, such as the market and competition for the mall (which was the principal source of parkers in the garage);
- Consider whether patrons of movie theaters in the mall might favor free parking at competing movie theaters;
- Evaluate the market and competition for the parking garage (such as competing lots, street parking and public transportation); or
- Identify or determine the nature and feasibility of a validation program (the owner of the movie theaters and other merchants resisted a program).

Spokane's experience underscores a lesson learned repeatedly in the context of land-based financings with respect to appraisers—the independence, assumptions and quality of the experts' work are critical and should not be taken for granted. A party's status as an "expert" does not obviate the need to review, discuss and question that party's work product.

Spokane is not the first issuer to experience liabilities despite an expert study, as illustrated by the *Dauphin County General Authority, Holmes Harbor, Sarbaz* and *Heritage Healthcare* matters, and the earlier *Nevada County, Ione, Miami* and *Orange County* matters, discussed or cited herein. All of those matters involved an issuer's reliance upon a professional appraisal, feasibility study or professional audit.

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[104] *In re River Park Square Project Bond Litigation*, Case No. CS-01-0127-EFS (Stipulation and Settlement Agreement at 6, 10, 11, 12, 13, 15, E.D. WA); *In re River Park Square Project Bond Litigation*, Case No. CS-01-0127-EFS (Second Stipulation and Settlement Agreement at 2-3, 4, 8, 10, 14-15, E.D. WA).

In summary, the Spokane litigation illustrates:

- The potential for actual substantial liabilities of municipal securities issuers in securities litigation;
- The status of bond insurers as potential plaintiffs in private disclosure litigation;
- Limitations on reliance by issuers on the advice of professionals;
- Inadvisability of employment of experts or professionals recommended by private third parties interested in completion of bond issues;
- Limitations on reliance by issuers on expert reports;
- Importance of heeding specific considerations regarding expert reports:
    - Independence of the expert,
    - The expert's identification and professional opinion as to the reasonableness of assumptions in the facts and circumstances of the bond transaction, and
    - Careful review of expert reports by issuers and other relying parties in the light of information known or readily-available to them; and
- The vitality and risks to issuers of state securities laws and common law.

Philadelphia Pay-To-Play Action

An issue receiving repeated SEC attention over the past decade is that of conflicts of interest in municipal securities issues. One concern is that conflicts may affect the level of investigation and quality of disclosure in bond issues, as well as indicating standards to which offering participants adhere.

The SEC considers the existence of conflicts of interest as a topic to be disclosed to investors. In addition to other considerations, the SEC cites political contributions from offering participants as a source of conflicts of interest (and therefore, potentially a subject for disclosure).

As the SEC stated in its 1994 release entitled "Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others:"

> Information concerning financial and business relationships and arrangements among the parties involved in the issuance of municipal securities may be critical to an evaluation of an offering.[105] Recent revelations about practices used in the municipal securities offering process have highlighted the

[105] The SEC's footnote states: *See SEC v. Washington County Utility District*, 676 F.2d 218, 222 (6th Cir. 1982) ("Flagrant violations" of antifraud provisions arising from failure to disclose use of proceeds to purchase options on property held by issuer's manager and financial arrangements between the manager and the underwriter).

> *potential materiality of information concerning financial and business relationships, arrangements or practices, including political contributions,* that could influence municipal securities offerings. For example, such information could indicate the existence of actual or potential conflicts of interest, breaches of duty, or less than arms' length transactions. Similarly, these matters *may reflect upon the qualifications, level of diligence, and disinterestedness of financial advisers, underwriters, experts and other participants in an offering. Failure to disclose material information concerning such relationships, arrangements or practices* may render misleading statements made in connection with the process, including statements in the official statement about the use of proceeds, underwriters' compensation and other expenses of the offering. In addition, *investors reasonably expect participants in municipal securities offerings to follow standards* and procedures established by such participants, or other governing authorities, *to safeguard the integrity of the offering process*; accordingly, material deviations from those procedures warrant disclosure.[106]

In recent years, some conflicts have been discussed under the rubric of "pay-to-play."[107] That is, a firm desiring to gain employment with an issuer may make political contributions or other payments, directly or through consultants, in various forms to issuer officials.

A recent evidence of such concerns appeared in criminal proceedings brought by the U.S. Attorney the City of Philadelphia pursuant to a 155-page Indictment.[108] Among other things, the indictment alleges the deprivation of honest services of a public official.[109]

As matters have unfolded, several investment banking firms and a number of their officers are alleged to have made payments through a bond counsel to a former City

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[106] SEC Rel. No. 33-7049, 34-33741, 59 F.R. 12748, 12751 (March 17, 1994). [Notes omitted; emphasis added.]

[107] Municipal Securities Rulemaking Board Rules G-37 and G-38 are directed specifically at the prevention of pay-to-play practices of municipal securities dealers. See Hume, "*NASD Starts Commerce Examination*," The Bond Buyer Online (Sept. 2, 2004), describing an investigation of whether a dealer violated those MSRB Rules. Some states also are acting in the area. See, *e.g.*, Shields, "*Illinois Rule Takes Effect, Bankers Must Now Comply With Contingency Ban*," The Bond Buyer Online (Aug. 2004).

[108] *U.S. v. White, et al*., Crim. No. ___ (Indictment filed June 29, 2004, E.D. PA).

See also *SEC v. Santos, et al*., 292 F.Supp.2d 1046 (N.D. Ill. 2003) denying a motion to dismiss the SEC's complaint against registered representatives of broker-dealers in connection with alleged cash payments and campaign contributions to, and as demanded by, a former Chicago City Treasurer in return for investment business from the City. The SEC alleged that the representatives violated SEC Rule 10b-5 when they failed to disclose the payments in proposals made to the City for investment services, even though the defendants may not have made affirmative false statements.

[109] See also *U.S. v. Campbell*, Case No. 1:04-CR-424 (Indictment dated Aug. 18, 2004, N.D. GA), relating to a former Mayor of the City of Atlanta with respect to payments alleged to have been made by a number of contractors.

Treasurer who had influence in City bond issue hiring practices and to have provided, directly or indirectly, other benefits to the former Treasurer.[110]

In addition, the SEC is reported to have commenced its own investigation of the alleged Philadelphia payments, as well as an investigation of "roughly half a dozen registered financial advisory firms located in the eastern part of the country to determine if they have engaged in pay-to-play practices in the municipal securities market."[111]

The proceedings are in their early stages.

The Philadelphia actions and subsequent reports illustrate that the SEC is continuing to pursue actions in the conflicts of interest and "pay-to-play" arenas, and that issuer officials implicated in such activities are at risk. The extent of other lessons to be learned will be determined by future events.

Sarbaz Action

Obligated persons[112] in municipal securities offerings also can be subject to treatment in disclosure actions similar to the treatment of securities issuers.

A prime illustration of the "obligated person" concept is developers in land-based financings who pay, and on whose land liens are placed to secure payment of, assessments, taxes or other charges to be used to pay principal of and interest on municipal securities.[113] Developers in land-based financings are "committed" by

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[110] Cataldo, "*U.S. Indicts Twelve in Philadelphia, Bond Counsel, Ex-Treasurer Named*," The Bond Buyer Online (June 29, 2004); D'Ambrosio, "*Four Plead Not Guilty in Philadelphia Corruption Case*," The Bond Buyer Online (June 30, 2004); D'Ambrosio, "*Three More Plead Not Guilty in Philadelphia Graft Case*," The Bond Buyer Online (July 2, 2004).

[111] Hume "*SEC Doing Pay-To-Play Examinations*," The Bond Buyer Online (July 1, 2004).

[112] In SEC Rule 15c2-12(f)(10), 17 C.F.R. §240.15c2-12(f)(10), the SEC defines the "obligated person" concept as follows:

> The term *obligated person* means any person, including an issuer of municipal securities, who is either generally or through an enterprise, fund, or account of such person committed by contract or other arrangement to support payment of all, or part of the obligations on the municipal securities to be sold in the Offering (other than providers of municipal bond insurance, letters of credit, or other liquidity facilities).

[113] The SEC explicitly cited developers in land-based financings as obligated persons:

> [M]ajor taxpayers in a municipal general obligation bond issue would not be included in the definition [of obligated person]; however, *an undertaking covering a developer that is the sole landowner in a development district assessment financing in which the future collection of assessments to service the borrowing is dependent upon the developer as part of the structure of the financing may be appropriate.* SEC Rel. 34-34961 at n.74 (Nov. 10, 1994). [Emphasis added.]

Investors have often made known their needs for financial information regarding developers in land-based financings:

"arrangements to support payment" of the municipal securities by virtue of participation in the subjugation of their land to levies of assessments, special taxes or other charges and their development activities intended to benefit bondholders.

Obligated persons provide essential credit information for disclosure in the municipal securities issues in which the obligated persons participate and from which they benefit.

The history of municipal securities enforcement actions is replete with land-based financings gone bad. Not only the obligated persons themselves, but governmental issuers (*e.g.*, Nevada County, California,[114] a Whatcom County, Washington, water district,[115] a Texas municipal utility district,[116] and the City of Ione, California[117]), financial advisors,[118] appraisers,[119] and underwriters,[120] repeatedly have been the subject of enforcement actions in connection with such offerings.

> [I]n order for this market to function efficiently, it is essential that financial information about the primary developers be provided in the official statement and on a continuing basis until their ownership of the land is diluted below a certain level (say 20%). If developers want to avail themselves of the public debt markets, they must be willing to make this information publicly available. If they wish to keep their financial operations private, they should seek other sources of borrowing.

Letter dated September 8, 1995, from William Oliver, Chairperson, National Federation of Municipal Analysts, and Jeffrey Baker, Chairperson, Industry Practices & Procedures Committee, National Federation of Municipal Analysts, to Paul S. Maco, Director of the Office of Municipal Securities, Securities and Exchange Commission.

See also National Federation of Municipal Analysts, **RECOMMENDED BEST PRACTICES IN DISCLOSURE FOR LAND-SECURED TRANSACTIONS** at 3, 6 (June 2000).

[114] *In the Matter of the County of Nevada, et al.,* SEC Rel. No. 33-7535 (May 5, 1998) [as to Nevada County].

[115] *SEC v. Whatcom County Water District #13, et al.*, Civ. No. C77-103 (W.D. WA); and SEC Lit. Rel. Nos. 7810 (March 7, 1977) (complaint filing), and 7592 (May 10, 1977) (settled final order).

[116] *SEC v. San Antonio Municipal Utility District No. 1, San Antonio Ranch Ltd. No. 1, Surety Savings Association*, Civ. Action No. H-77-1868 (Complaint dated Nov. 10, 1977, S.D. TX).

[117] *In the Matter of the County of Nevada, et al.,* SEC Rel. No. 33-7537 (May 5, 1998) [as to the City of Ione].

[118] *E.g.*, *In the Matter of County of Nevada, et al*., Initial Decision Rel. No. 153 (Oct. 29, 1999) [as to Virginia Horler]; *In the Matter of Allen*, SEC Rel. Nos. 33-7456, 34-39122 (Sept. 24, 1997); *In the Matter of County of Milbrodt*, SEC Rel. Nos. 33-7455, 34-39121 (Sept. 24, 1997).

[119] *E.g.*, *In the Matter of County of Nevada, et al*., SEC Rel. Nos. 33-7556, 34-40225 (July 17, 1998) [as to William McKay].

[120] *See, e.g.*, *In the Matter of Walston & Co.*, SEC Rel No. 34-8165 (Sept. 22, 1967); *In the Matter of Hanauer & Co*., SEC Rel No. 34-9099 (March 12, 1971); *SEC v. San Antonio Municipal Utility District No. 1, San Antonio Ranch Ltd. No. 1, Surety Savings Association*, Civ. Action No. H-77-1868 (Complaint dated Nov. 10, 1977, and Stipulations of Settlement dated Nov. 10 and 16, 1977, S.D. TX);

An example of actions involving obligated persons is a recent action, *SEC v. Sarbaz*, affecting a developer (and its controlling officer individually) and an appraiser in a series of land-based financings.[121] Following the trial, the federal Court determined that a permanent injunction should issue against the defendants and that it was appropriate to impose $4.9 million in civil penalties against the developer and $980,00 in civil penalties against the developer's controlling person. That was less, however, than the $17 million in civil penalties and $17 million in disgorgement sought by the SEC due to the Court's inability to find that the defendants "actually profited" from their actions.[122]

Among other things, the action replays the familiar themes of a failure to disclose appropriately information regarding a developer and the SEC's challenge to methodology and disclosure regarding land appraisals.

The appraiser settled with the SEC, agreeing to entry of a permanent injunction against further securities law violations and to payment of $77,000 in disgorgement and pre-judgment interest.[123]

In addition, the underwriter had been the subject of the only injunction ever issued in securities litigation to halt a municipal bond issue in progress,[124] again reflecting that multiple transactional participants may be subject to remedies in poorly-disclosed transactions.

In summary, the Sarbaz action illustrates the following:

- The importance of heeding precedent in SEC enforcement actions;
- Risks for developers and their officials in land-based financings;
- The importance of disclosure of developer information in such offerings;
- How developers may be subject to remedies, even when others involved in securities transactions may be subject as well to allegations of securities law violations;

SEC v. First California Capital Markets, et al., SEC Lit. Rels. Nos. 15423 (July 28, 1997) (complaint filing) and 16107 (Apr. 7, 1999) (settlement); *SEC v. Fitzgerald and Pacific Genesis Group, Inc*., Civ. No. C-00-4802 (CRB) (N.D. CA), SEC Lit. Rels. Nos. 16854 (Jan. 4, 2001) and 16907 (Feb. 23, 2001).

[121] *SEC v. Sarbaz, et al.*, Case No. 03-1310 JSL (CTX) (Complaint filed Feb. 27, 2003, C.D. CA); SEC Lit. Rel. No. 18001 (Feb. 26, 2003).

[122] *SEC v. Sarbaz, et al.*, Case No. 03-1310 CJC (CTX) (Proceedings (In Chambers): Order Re Decision After Trial dated July 13, 2004, C.D. CA); Hume, *"$6M in Fines Proposed for Sarbaz & Firm*," The Bond Buyer Online (July 16, 2004).

[123] *SEC v. Sarbaz, et al*., Civ. No. SACV 03 881 CJC (Final Judgment of Permanent Injunction and Other Relief as to Defendant Lee Andrew Hill dated May 13, 2004, C.D. CA).

[124] *SEC v. Fitzgerald and Pacific Genesis Group, Inc*., Civ. No. C-00-4802 (CRB), SEC Lit. Rels. Nos. 16854 (Jan. 4, 2001) and 16907 (Feb. 23, 2001).

- The importance in such offerings of independent professional appraisals based upon reasonable assumptions; and
- The importance of careful review, in the light of known or readily-available information, of the assumptions and methodology utilized by appraisers.

Heritage Healthcare Bonds

In the municipal securities market, governmental issuers sometimes function essentially as conduits in order to benefit private businesses with tax-exempt bond issues satisfying complex federal tax private activity rules. The SEC generally considers the private borrowers in such conduit transactions also to be "issuers" of separate securities in the financings.[125] In essence, the proceeds of sale of the bonds are used to finance projects benefiting the private borrowers, and the private borrowers agree to make payments to be used to pay principal of and interest on the governmental issuers' bonds.

The separate securities are the private parties' obligations, usually in the form of notes, loan agreements, installment purchase agreements or lease purchase agreements. Thus, there may be, and often are, multiple "issuers" in private activity bond issues.[126]

Heritage Healthcare,[127] one such private borrower/issuer, engaged, through various nonprofit corporations, in a series of bond issues for Alzheimer's treatment and other health care facilities. The bond issues defaulted. Extensive private litigation is in progress. For example, in just one of several cases, pursuant to a 188-page Complaint, investors make extensive allegations against multiple parties, and the litigation is likely to last for years.[128] Securities litigation can move slowly, at times requiring as much as five to even ten years.

With respect to expert reports, various official statements used in the offerings make assertions with similarities to the following:

> Neither the Issuer, nor the Underwriter, nor their counsel, nor Bond Counsel not any other party other than the Company has reviewed the assumptions and

[125] SEC Rules 131, 17 C.F.R. §230.131, and 3b-5, 17 C.F.R. §240.3b-5.

[126] SEC Rule 15c2-12(f)(4) defines the term "issuer of municipal securities," as follows:

> The term "*issuer of municipal securities*" means the governmental issuer specified in section 3(a)(29) of the Act and the issuer of any separate security, including a separate security as defined in rule 3b-5(a) under the Act.

[127] In this paper, the name "Heritage Healthcare" is used to represent a group of private corporations under largely common control acting in various capacities in the bond issues.

[128] See Shields, "*Heritage Bondholders' Lawsuit Gets Class Action Status*," The Bond Buyer Online (July 12, 2004). Complaints were filed initially in 2002 in what has become multidistrict litigation. *In re Heritage Bond Litigation*, MDL No. 02-1475 1475 (Consolidated Fifth Amended Complaint dated Feb. 12, 2003, C.D. CA).

> the disclosures contained in the Financial Feasibility Study and found the assumptions to be reasonable.[129]

Nevertheless, official statements advised investors that "The Financial Feasibility Study included … should be read in its entirety."[130]

The SEC also commenced enforcement proceedings relating to 11 bond issues against officials of the private issuer/developer, underwriter counsel/bond counsel and officials of the underwriter.[131] The bonds were issued by governmental issuers in Texas, Florida, Illinois and California.

In part, the Commission alleged, in its action, that proceeds of various bond issues, although represented to be for the purpose of financing separate projects, were commingled, and served as a form of Ponzi scheme, when proceeds from later issues were diverted to pay costs associated with other bond issues. In addition, the SEC alleged certain conflicts of interest, in that proceeds are alleged to have been used to benefit a "controlling person" of the private borrower/issuer and members of his family. Further, underwriter counsel (who is alleged to have served as bond counsel in one issue) is alleged too have shared fees with the controlling person.[132]

The "controlling person" was not an official of the borrower(s), but allegedly exercised control through a management company and influence over employee responsibilities and expenditure decisions.[133]

According to the Commission's allegations, the legal counsel and underwriter officials served in the offerings despite knowledge of the commingling and diversion of funds.

In summary, the *Heritage* actions illustrate:

- Risks in the municipal securities market for private conduit issuer/borrowers;
- The breadth and flexibility of the "controlling person" concept;
- Importance of careful review of feasibility studies, including assumptions and methodology, in order to establish sound reliance; and

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[129] *E.g.*, Official Statement dated July 10, 1998, at 59.

[130] *Id.*

[131] *SEC v. Kasirer, et al.*, Case No. 04-C4340 (N.D. Ill.), SEC Lit. Rel. 18774 (July 1, 2004); Shields, "*SEC Targets Heritage*," The Bond Buyer Online (July 2, 2004); Shields, "*SEC Charges Five With Fraud Over Defaulted Heritage Healthcare Deal*s," The Bond Buyer Online (July 1, 2004).

[132] *SEC v. Kasirer, et al.*, Case No. 04-C4340 (Complaint at ¶¶34, 37-40, 49-62, N.D. Ill.).

[133] *SEC v. Kasirer, et al.*, Case No. 04-C4340 (Complaint at ¶¶41-62, N.D. Ill.).

- The importance of heeding precedent in SEC enforcement actions—in this case, disclosure of conflicts of interest,[134] and uses of proceeds of municipal securities offerings.[135]

Mojave Valley Resort

As this paper was nearing completion, the SEC announced an action and settlement in yet another defaulted land-based financing. In that case, the defendants in federal Court, Mojave Valley Resort, Inc. and Mark A. Temple, agreed to pay nominal disgorgement and $40,000 in civil penalties and to issuance of a permanent injunction against further federal securities law violations.[136]

The allegations relate to statements in the official statement as to the developer's ability to enter into a mortgage of the developer's leasehold interest from a Native American tribe. According to the SEC's allegations, the developer could not mortgage its interest.

The Mojave Valley Action illustrates once more the risks of land-based financings and the need for special care in making disclosure in that high-risk setting.

A Note About Continuing Disclosure

The current round of litigation does not include allegations regarding continuing disclosure violations by municipal securities issuers and obligated persons. Continuing disclosures are required in connection with most municipal securities offerings, other than variable rate or privately-placed transactions, by means of issuer and obligated person undertakings. Under Rule 15c2-12(b)(5),[137] underwriters are forbidden to underwrite those offerings without the undertakings. The undertakings are to relate to annual disclosure of information specified in the official statements and to the occurrence of designated events.

As a caution, it also is important for issuers and officials to be careful in preparing their continuing disclosure reports and in providing information, accessible to investors on issuer websites.[138] The City of Miami was cited for disclosure violations in an annual financial report which the City filed pursuant to such an undertaking. In that connection, the SEC stated:

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[134] See the text accompanying n. 106, *supra*.

[135] See, *e.g.*, *In the Matter of Maricopa County*, 33-7354, 34-37779 (Oct. 3, 1996) (proceeds of general obligation issue used temporarily to fill County shortfall in cash flow).

[136] *SEC v. Mojave Valley Resort, Inc. and Mark A. Temple*, Case No. ED CV 04-1061 VAP (Final Judgments of Permanent Injunction dated Aug. 30, 2004, against Mark A. Temple and Mojave Valley Resort, Inc., C.D. CA); SEC Lit. Rel. No. 18852 (Aug. 25, 2004); Hume, "*California Developer to Pay $40,000 to Settle Securities Fraud Case*," The Bond Buyer Online (Aug. 25, 2004).

[137] SEC Rule 15c2-12(b)(5), 17 C.F.R. §240.15c2-12(b)(5).

[138] See Doty, "*Local Governments, Securities Laws and Websites*," Municipal Lawyer (Jan./Feb. 2004).

> Miami's financial disclosures would be no less important to investors, who held previously issued City bonds, and were entitled not to be mislead about Miami's current financial condition in deciding whether to hold or sell their bonds. "Information about the issuer and other obligated persons is as critical to the secondary market … as it is in primary offerings."[139]

Summary

Recent actions demonstrate that securities law responsibilities of issuers (and officials) are continuing to evolve significantly, and at times dramatically, through SEC enforcement and private litigation. The activity of recent months illustrates the wide variety of subjects and settings within which allegations of disclosure violations may arise, and the importance of careful drafting and issuer review of disclosure language.

One repeated crucial message is that the SEC expects issuers to take responsibility for their disclosure documents. While other parties continue to have their own responsibilities, that does not relieve issuers or officials of their important roles.

Issuers and officials may begin to perceive that legal and financial professionals, responding to the SEC's initiatives as to the professionals' responsibilities to issuers, are providing more explicit and specific advice. Issuers may also find, over time, that better qualified professionals are less willing, especially in riskier transactions, to perform cut-rate services.

Most importantly, from the perspective of issuers, the issuers and their officials should become more active in their own interests and for their own protection. For example, issuer officials need not only to review, but also to understand, the documents they approve and sign. Yet, that is not enough by itself.

In the SEC's view, it is not sufficient to ask for general assurances from bond professionals that all appropriate disclosures have been made and that the an issuer's official statement is materially accurate and complete. In their own interests, given these recent developments, issuers and officials also need to ask questions and receive assurances on specific disclosure issues, and on particularly important ones, receive written formal opinions and advice.[140]

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[139] *In the Matter of the City of Miami*, SEC Rel. No. 33-8213, 34-47552 text accompanying n. 31 (Opinion of the Commission, March 21, 2003). [Note omitted.]

[140] Aside from remedying wrongs, the SEC's enforcement activity also serves the valuable function of educating market participants as to the Commission's views of their roles and responsibilities. It is especially helpful when the Commission is explicit in identifying what a respondent or defendant has done wrong.

When such identification goes beyond merely concluding that particular misstated or omitted information is "material," market participants are better able to take that guidance into account in framing their own behavior. The themes often are repeated. Hence, the importance of heeding precedent from SEC enforcement actions.

From the latest round of actions, however, it does not appear to be sufficient for issuers to stop even there. Issuers are well-advised to consider carefully the information known or readily available to them, whether that information may be potentially material to investors, and if so, whether that information is disclosed appropriately.[141]

That may be difficult, especially when complex documents go beyond the experience of issuer officials, when issuer officials do not know what information various types of reasonable investors may need, or when information is ambiguous or uncertain. Yet, those circumstances may be precisely the ones presenting the greatest need for care.

The Commission itself, however, sometimes is ambiguous in the expression of its own views as to what is required going forward. In the *Nevada County* action, for example, some years ago, Nevada County had sought independent advice of a professional financial advisor on specific questions. The financial advisor rendered explicit advice, as reflected in minutes of the County's Board of Supervisors and in written advice, that an appraisal of a developer's land was a good appraisal. Nevertheless, the County was criticized for erroneous information in the appraisal. The County also resisted pressures from bond counsel to proceed with the transaction until the County had received additional assurances regarding the title to the subject property.

In neither the *Nevada County* release nor the *Ione* release did the Commission express a finding or allegation that the County or the City had knowledge of to inaccuracies in the developer's information included in the official statements.

The *Nevada County and Ione* actions occurred in the 1990s. Perhaps, as was done to some extent in the *Neshannock School District*, *Dauphin County General Authority* and *MTA* actions, *supra*, the SEC will be more explicit in the future regarding what it believes specific issuers (and officials) have done wrong, apart from simply not making appropriate disclosures. There needs also to be some explanation of how the issuers (and officials) were at fault—what specific negligent or reckless actions they committed, what standards of care they violated, or what knowledge or fraudulent intentions they may have had.

[141] Taking into account the inquiries and investigations conducted by several issuers discussed in this paper, issuers and officials would be well-advised to resist advice of bond professionals when the issuers and officials continue to have questions or otherwise are not fully satisfied by responses. At times, it may be advisable to seek further advice from additional outside sources.