



RECENT DISCLOSURE PROCEEDINGS AGAINST MUNICIPAL ISSUERS CLARIFY RESPONSIBILITIES

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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 in the mid-1970s (when payments on New York City obligations were deferred for a significant period, with interest, pending a re-structuring of City finances). Altogether there are at least 74 SEC and California Department of Corporations enforcement actions against issuers and obligated persons and 50 against state and local officials and obligated persons since New York's moratorium, not including dozens of private actions.

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

The recent SEC actions expanded issuers' disclosure horizons in important ways. The general rule expressed by the SEC² 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

Taken as a whole, the actions discussed in this article underscore for issuers and state and local officials the importance of inserting themselves directly and actively into the disclosure process, if they have not done so already. Certainly, the SEC's actions and issuer (and state and local official) liabilities point strongly to the need for direct participation in active disclosure practices.

The following article summarizes recent SEC actions and lessons learned from them, which reinforce the reasons why such reviews by issuers themselves are essential. In each instance cited below, issuers either asked questions of others and relied upon the responses or were in the process of an active internal investigation of information. Nevertheless, the issuers (and some state and local officials and obligated persons) experienced negative consequences when information to which they had access to was not disclosed appropriately.

Neshannock Township School District

Municipal issuer risks were increased as a result of the SEC's April 2004 action against a small Pennsylvania school district, Neshannock Township School District.⁴ In that enforcement action, the SEC, for the first time, went beyond merely ordering the issuer to cease and

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² Litigation documents, including SEC releases, cited in this paper are available at <http://www.agfs.com/securitieslaws.asp>.

³ SEC Rel. No. 34-26100, 53 F.R. 37778, 28811 n.84 (July 10, 1989).

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

desist committing antifraud violations, but also imposed the added monetary penalties of “disgorgement”⁵ and “prejudgment interest.”⁶ The Internal Revenue Service (IRS) had determined previously that interest on the District’s notes was taxable, resulting in another payment by the District to the IRS to preserve the tax-exempt status of the notes.

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 ill-defined at the date of note issuance. The District invested the note proceeds almost to maturity.

The District’s actions presented questions about the tax exemption for the notes. Federal tax rules allow a “temporary period” during which note proceeds may be invested, but that assumes an intention to use the proceeds eventually for projects.

The District’s board members had notice that there could be problems with the transaction. Indeed, some board members “were initially skeptical about the financing proposal”⁷ and “raised questions”⁸ with legal counsel and the underwriter. After those discussions, the school board unanimously approved the transaction. In the process, the District made inaccurate representations in the District’s OS and also in a closing arbitration certificate.⁹ The certificate, which had been drafted by legal counsel, contained representations that the District intended to expend funds on capital projects. The SEC concluded that the District should have disclosed to investors the potential risks regarding the loss of the tax-exempt status of the bonds.

The SEC’s Neshannock release highlights monetary risks for municipal issuers, even when state and local officials ask questions and receive assurances from legal and finance professionals. District statements in its OS and closing arbitration certificate¹⁰ may have appeared superficially accurate due to the District’s general intentions to construct projects. Nevertheless, in the SEC’s view, the representations were not materially accurate as to the specific use of the note proceeds, and hence as to federal tax risks important to investors.

Dauphin County General Authority

An April 2004 SEC action against the Dauphin County, Pennsylvania, General Authority,¹¹ related to an Authority bond issue to finance acquisition of an office building. According to the SEC, “the Authority members read little, if any, of the Preliminary OS prior to their vote”¹² approving the document and authorizing its distribution. The SEC alleged in a related action against the Authority’s financial advisor and underwriter, that counsel to the underwriter had drafted the Authority’s OS. Therefore, the Authority’s disclosure document was prepared by a legal counsel who did not have a contractual relationship with the Authority. The SEC asserted, however, that “The Authority was responsible for the contents of the OS.”¹³

The Dauphin County bonds were payable from tenant lease rentals in the acquired building. Much of the space (90 percent) was occupied by Commonwealth of Pennsylvania departments, including the Department of Transportation (DOT) (80 percent, providing 60 percent of revenues). The DOT’s lease, however, was for only three years, after which the DOT was to move to a new building. Upon the DOT’s move, the bond defaulted because the principal source of repayment no longer existed. Despite a tight real estate market (which was mentioned in an appraisal included in the Authority’s OS), tax laws severely restricted the Authority’s ability to lease space to private tenants.

⁵ Disgorgement is a remedy pursuant to which the District was required to relinquish “ill-gotten gains,” as opposed to paying damages to investors. It appears that no investors suffered any actual monetary losses, since a payment was made to the IRS to preserve the tax-exemption of interest on the District’s notes.

⁶ 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.

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

⁸ *Ibid.*

⁹ An arbitration certificate is a highly complex tax certificate 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, an arbitration certificate is almost always prepared by legal 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.

¹⁰ The notion that a closing certificate is a disclosure document was set forth several years earlier against numerous small general governmental issuers in *In the Matter of Coahoma County, MS, et al.*, SEC Rel. Nos. 33-7554, 34-40194 (July 13, 1998).

¹¹ *In the Matter of Dauphin County General Authority*, SEC Rel. No. 33-8415 (Apr. 26, 2004).

¹² *Ibid.*

¹³ *Ibid.*

Prior to the bond issue, “various Authority Board members and professional advisors expressed concerns”¹⁴ about what would happen after the DOT moved. The Authority’s financial advisor, executive director, and others investigated, meeting with a Pennsylvania official with authority to enter into such leases who declined to commit to future leases, but remained opened to the possibility. Thus, the Authority’s executive director was aware of Pennsylvania’s posture. The Authority’s OS disclosed this risk:

[t]he office leases are scheduled to expire prior to the maturity of the Series 1998 Bonds; there is no commitment, requirement or guarantee that the Commonwealth will renew or extend any of the office leases.¹⁵

The SEC considered this statement to be misleadingly general and imprecise, in that the statement “impl[ie]d that there was at least a possibility that Pennsylvania would renew or extend the leases.”¹⁶ The statement failed to disclose the specific information that the DOT would be moving in three years, vacating the majority of the building. In that regard, a news article paraphrased a SEC attorney as follows:

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 ...¹⁷

Assertions that the planned move by the DOT was well-known locally 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 information. It’s the obligation of the underwriter and the issuer to collect that information and present it to the investors.¹⁸

As noted above, the SEC also has commenced an action against the Authority’s financial advisor and the underwriter.¹⁹ In that pending action, the SEC alleges that the Authority relied upon advice of its financial advisor regarding the structure of the transaction and content of the OS and that the financial advisor had a fiduciary relationship to the Authority. The results of the action are yet to be determined. Nevertheless, issuers may not gain much comfort from the fact that actions also may be brought against other transactional participants, including some upon whom the issuers rely.

Massachusetts Turnpike Authority

Disclosure in the context of ambiguous and uncertain information was a key issue in a SEC action against the Massachusetts Turnpike Authority (MTA) and the Authority’s Chairman.²⁰ 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.

Despite the Chairman’s “effort to control costs,” the SEC considered the MTA and the Chairman personally to have committed violations for failure to disclose known information as to the existence of cost overruns that were of an unknown, but apparently significant, amount. It is worth observing that many of the bonds were backed by Massachusetts’ general credit and some were insured.

¹⁴ *Ibid.*

¹⁵ *Ibid.*

¹⁶ *Ibid.*

¹⁷ Hume, “SEC Enforcement Case Shows General Disclosure Not Enough,” *The Bond Buyer Online* (Apr. 27, 2004), paraphrasing comments of Mark Zehner.

¹⁸ *Ibid.*

¹⁹ “Commission Charges Public Finance Consultants, Inc., Robert Fowler, Dolphin and Bradbury, Incorporated, and Robert Bradbury with Violations of the Antifraud Provisions of the Federal Securities Laws in Connection with a \$75.35 Million Offering of Municipal Securities,” SEC Rel. Nos. 33-8414, 34-49619 (Apr. 26, 2004); *In the Matter of Public Finance Consultants, Inc., Robert D. Fowler, Dolphin and Bradbury, Incorporated, and Robert J. Bradbury*, Order Instituting Public Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933 and Sections 15(b), 15B and 21C of the Securities Exchange Act of 1934, Admin. Proc. 3-11465 (Apr. 26, 2004).

²⁰ *In the Matter of The Massachusetts Turnpike Authority and James J. Kerasiotes*, SEC Rel. No. 33-8260 (July 31, 2003).

City of Spokane

In federal and state securities law litigation against the City of Spokane relating to revenue bonds for parking facilities benefiting a private shopping mall developer, the City agreed, partially in consideration of an assignment of investors' claims against other offering participants, to pay from City funds all of the outstanding bond principal and unpaid accrued interest.²¹ For the payment (and to pay IRS penalties), the City intends to issue up to \$39 million in new bonds backed by the City's credit. The City had asserted reliance, in connection with the offering, on various feasibility experts, legal and financial professionals, and the project developer.

Lessons for Issuers

The actions illustrate several critical lessons for issuers:

- Although some may seek to minimize potential issuer liability risks, litigation costs, as well as remedies, can be significant; issuers and state and local officials should take those risks very seriously when bond issues are structured and marketed.
- Issuers (and state and local officials) should pay attention to questions raised in prior SEC and private actions.
- Issuers (and state and local officials) can be exposed to actual monetary liabilities.
- Enforcement actions may be instituted and remedies may be imposed even when investors do not lose money.
- Issuers (and state and local officials) cannot simply rely on legal and finance professionals, or other parties, when one or more issuer representatives know of, or have substantial notice as to, disclosure violations.
- Material information that is ambiguous or uncertain nevertheless should be disclosed with careful attention to describing the ambiguities or uncertainties.
- Even statements that are literally accurate may mislead due to omission of relevant information.
- General disclosure of risks omitting specific known 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.
- State securities laws also create significant responsibilities for issuers (and state and local officials).

Summary

Recent actions demonstrate that securities law responsibilities of issuers (and state and local officials) are continuing to evolve significantly through SEC enforcement and private litigation. The activity of recent months illustrates the wide variety of subjects and settings within which disclosure violations may occur and the importance of careful drafting and issuer review of disclosure language. One recurrent theme is that the SEC expects issuers to take responsibility for their disclosure documents, even if other parties have contractual responsibilities.

Therefore, issuers and state and local officials should be active in their own interests. That should occur by asking questions and receiving assurances, and also by reviewing carefully, in the light of known or readily-available specific information, the offering and closing documents the issuers and state and local officials approve and execute. That may be difficult, especially when complex documents go beyond the experience of issuers, or when information is ambiguous or uncertain, but those circumstances may be precisely the ones presenting the greatest need for care.

²¹ *In re River Park Square Project Bond Litigation*, Case No. CS-01-0127-EFS (Stipulation and Settlement Agreement) (E.D. WA); *In re River Park Square Project Bond Litigation*, Case No. CS-01-0127-EFS (Second Stipulation and Settlement Agreement) (E.D. WA). Certain professional firms also have entered into settlements.

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