
Justice Mulls False Claims Act Charges Against Issuers, Borrowers, MAs.

WASHINGTON — The Justice Department is considering filing civil lawsuits under the False Claims Act against at least five issuers and borrowers, as well as two municipal advisors, for allegedly misusing the Treasury Department's state and local government series securities to exploit interest rates and obtain tens of millions of dollars.

The issuers and borrowers include: Greenville County, S.C., School District; Nationwide Children's Hospital in Franklin County, Ohio; Gulf Breeze, Fla.; the Louisville and Jefferson County Metropolitan Sewer District in Kentucky; and The University Financing Foundation in Georgia, according to documents obtained by The Bond Buyer, bond-related disclosures, and sources.

The municipal advisors are Christopher Monaghan and Michel Garner, who were principals of the now-defunct Enhanced Financial Solutions LLC and are now principals at Echo Financial Products, both based in Pennsylvania. EFS set the five issuers and borrowers up in proprietary "yield enhancement programs" for state and local government series securities (SLGS), according to filings with the Securities and Exchange Commission by Echo.

EFS was affiliated with Pottstown, Pa.-based Investment Management Advisory Group (IMAGE), which shut down following a Justice Department antitrust investigation of bid-rigging of guaranteed investment contracts and other muni bond investments.

EFS' yield management program monitored interest rates and purchased SLGS for the issuers and borrowers, then redeemed and/or modified them when rates changed to obtain redemption premiums.

An issuer, for example, would buy 20-year SLGS, hold them for 30 days, and, if interest rates dropped, sell them back to Treasury at higher prices.

The issuers made huge amounts of money over several-year periods. Greenville County School District, the largest school district in South Carolina, made $67.7 million from 2007 through 2012, the Louisville and Jefferson County MSD made $114.60 million from 2008 through 2011, and Gulf Breeze made almost $64.2 million between 2007 through 2012, according to Treasury documents obtained through the Sunshine Act.

DOJ earlier this year sent letters to the issuers, borrowers and MAs saying it had opened a civil investigation into whether the yield enhancement programs' alleged violation of SLGS rules "implicated" the False Claims Act (FCA).

The FCA imposes liability on persons and companies who defraud governmental programs. It is the federal government's primary litigation tool to combat fraud against the government.

Sources believe Treasury asked DOJ to help it recover some of the ill-gotten gains from the SLGS transactions.

If DOJ filed False Claims Act charges against the issuers, borrowers and MAs and prevailed, it could obtain triple damages as well as $5,500 to $11,000 per claim.

DOJ told the issuers, borrowers, and MAs that it could take other action, such as filing suits charging them with common-law breach of contract, fraud, or unjust enrichment.

But DOJ's preference, according to the letters it sent the alleged violators, would be to settle the disputes over the SLGS transactions without resorting to litigation.

The issuers and one borrower said they are cooperating with DOJ.

"The investigation remains in its early stages, and the hospital has had only preliminary discussions with DOJ to this point," Nationwide Children's Hospital said in the official statement for $129.3 million of revenue refunding bonds Franklin County, Ohio sold for it. "At this point the hospital cannot predict the outcome of the DOJ investigation, including the potential materiality of any monetary consequences."

All but one of the other issuers and borrowers made similar disclosures in bond documents. Some made statements to The Bond Buyer and provided documents under the Sunshine Act.

Officials with The University Financing Foundation refused to comment and did not make any disclosures. Nationwide Children's Hospital officials said they could not comment further than their disclosure because of the ongoing investigation.

A Treasury spokesman said the department probably would not be able to provide documents because of an ongoing investigation and privacy issues. But some issuer officials talked about the DOJ probe.

Doug Webb, general counsel for the Greenville County School District, told The Bond Buyer, "The school district participated in the [SLGS] program from 2007 to 2013. This program was administered by a financial services provider on behalf of the school district and was also utilized by other municipal bond issuers. The school district used this investment program for the sole benefit of its students and constituents."

Gulf Breeze city manager Edwin Eddy said, "We are not taking it lightly. We hired a law firm, and determined that other agencies received the same legal advice we did. We're taking it seriously to make sure we are prepared."

The issuers, borrowers and MAs, who don't think they did anything wrong, have hired lawyers that specialize in tax and government controversies, as well as the False Claims Act. The Greenville County School District is being represented by Bryan Cave, their lawyers said. The Louisville and Jefferson County MSD has hired Brad Waterman, a lawyer with his own tax controversy practice. Gulf Breeze has hired Jenner & Block. Several other bond counsel and law firms are involved. Michael Schwartz, a former U.S. attorney who is now a partner at Pepper Hamilton in Philadelphia, represents Monaghan and Garner and EFS. Most of these lawyers, with the exception of Schwartz, either could not be reached for comment or declined to comment.

SLGS Program

The SLGS program was created in 1972. SLGS are non-marketable special purpose securities issued by Treasury and purchased by state and local governments to help them comply with yield restriction and rebate requirements on their investments of bond proceeds.

SLGS are often purchased by issuers for their advance refunding escrows as alternatives to open-market Treasuries. Their maturity dates can be tailored to those of the bonds being refunded. But issuers can invest other bond proceeds in them as well.

In Gulf Breeze, reserve funds and replacement funds were invested in SLGS, documents show. The city also purchased SLGS with some of the proceeds from a $500 million variable-rate local government pool bond program that began in 1985 to provide loans to municipalities across the state.

In 1996, Treasury revised its rules to make SLGS more flexible for issuers. A year later, Treasury amended the SLGS rules to halt perceived abuses. The preamble to the rules said the amendments were to prohibit issuers from purchasing both SLGS and open-market Treasuries for the same advance refunding escrow as a "cost-free interest rate hedge or option for speculation in open market securities." The rules contained examples of impermissible transactions involving purchase of both SLGS and open-market Treasuries.

In 2005, Treasury published final SLGS rules that expanded the examples of impermissible transactions, but all of the examples involved interest rates exploited through the use of SLGS and open-market Treasuries. None of the examples involved just SLGS.

SLGS Transactions

In September 2006, March 2008 and February 2012 letters, C. Willis Ritter, a lawyer at Ungaretti & Harris at that time who served as both special tax counsel and special SLGS counsel to Gulf Breeze and helped prepare its SLGS agreement, assured Gulf Breeze and later other issuers that the yield investment program did not violate SLGS rules and would not warrant any enforcement action from Treasury, according to documents.

Ritter had said in an earlier brief sent to clients and obtained by The Bond Buyer that the 2005 final SLGS rules "indicated" it was permissible to do these transactions. He could not be reached for comment.

Treasury became aware of EFS' yield enhancement program and in October 2013 it began an administrative process to determine if the program violated SLGS rules. Treasury officials created a SLGS working group comprised from departmental staff to review the transactions done under the program and to submit a report and recommendations on those transactions. The department gave the issuers, borrowers and MAs the opportunity to tell it why their investment programs didn't violate SLGS rules.

In December 2013, the late Frederic "Rick" Ballard, with Ballard Spahr, responded to Treasury on behalf of EFS, the Greenville County, S.C. School District, Gulf Breeze and Nationwide Children's Hospital. He, like Ritter, said that Treasury had given an "implied" approval to these SLGS deals when it specifically proposed prohibiting them in the Notice of Proposed Rulemaking for the final rules, but then deleted that section from the final 2005 rules.

Ballard also said the issuers and borrowers had relied on counsel and that the transactions took place over an extended period of years, openly in filings with Treasury's Bureau of Fiscal Service.

"EFS and the [SLGS] purchasers were not trying to hide anything from anyone," he said.

Treasury Probe and Sanctions

In 2014, then-Treasury Fiscal Assistant Secretary Richard Gregg sent letters informing the issuers, borrowers and MAs that EFS' yield enhancement program violated SLGS rules when they:
purchased a long-term SLGS security and redeemed it before maturity to capture a redemption

premium; changed the maturity or interest rate of a SLGS security already subscribed for to take advantage of interest rate movements; and changed the SLGS subscription amount, in response to movements in interest rates, in order to maximize redemption premiums or minimize potential losses.

Based on the SLGS Working Group recommendations, Treasury suspended the issuers and borrowers from the SLGS program for five years. Treasury permanently barred Monaghan and Garner from the program, according to disclosure documents and Echo's filings with SEC.

Then earlier this year DOJ opened up its investigation.

Defenses
The issuers, borrowers and MAs are pushing back against DOJ on several fronts. First, they don't think they did anything wrong. They had opinions from bond counsel, special tax counsel, SLGS counsel and financial advisors that the SLGS transactions did not violate SLGS rules. They say they relied on these opinions.

"When it comes to dealing with the Justice Department, if you have an opinion that was written in good faith, there is no basis to go after the person relying on that opinion for any kind of fraud or improper conduct," Schwartz said.

The issuers, borrowers and MAs also say they openly bought and sold the SLGS over many years and Treasury never questioned the purchases and sales.

In addition, they said that, when informed by Treasury that their transactions violated SLGS rules, they stopped doing them and that Treasury sanctioned them with the suspensions. They thought this meant the case was closed.

"When we received word back from the Department of the Treasury that we shouldn't be doing that, we said, 'OK, we'll stop immediately,'" said Eddy.

In letters sent to them regarding the suspensions, Treasury said, "This constitutes the FINAL AGENCY ACTION in this matter. The decision will not be reconsidered and may not be appealed to any other officials in the department of the Treasury." It said, however, that the issuers and borrowers could seek judicial review of Treasury's findings and actions.

The issuers and MAs said they didn't agree with Treasury but didn't contest the suspensions.

But sources said federal officials contend Treasury had no way to impose penalties or recoup ill-gotten gains for the SLGS violations under the SLGS rules. The 2005 rules list the remedies available to Treasury for abuses. They include rejections of SLGS subscriptions and suspension or revocation from the SLGS program. The rules don't permit Treasury to seek penalties, sources said.

"You've got to remember that this is a Treasury borrowing program," said one source who did not want to be identified.

Some lawyers representing the issuers and borrowers argue that DOJ will never be able to file charges against the issuers and borrowers under the FCA because it bars tax claims. They said the SLGS program involves tax rules because it is designed to help issuers comply with arbitrage and yield restriction rules.

They point to Michael Lissack's False Claims Act suit against Sakura Global Capital Markets, which was shot down by the U.S. Court of Appeals for the Second Circuit in New York City because it involved tax claims.

Lissack accused Sakura of yield burning, which means selling issuers open-market Treasuries at inflated prices to "burn" down their investment yields. Appeals court judges dismissed the suit because the FCA contains a "tax bar" that excludes coverage of all "claims, records, or statements made under the Internal Revenue Code of 1986."

But Lissack was successful in filing FCA charges against broker-dealers for yield burning and his charges involved SLGS. Lissack argued that by getting issuers to invest in open-market Treasuries, the broker-dealers deprived Treasury of SLGs subscriptions and the revenue from that program that it normally would have had.

In April 2000, 17 regional and national broker-dealers and investment advisors agreed to a total of $140 million to settle the charges. Lissack made millions of dollars from the settlements.

In this latest SLGS controversy, Schwartz said, "We are fully cooperating with the Department of Justice and expect that when it thoroughly reviews all of the evidence it will determine that there is no basis to believe that Enhanced Financial did anything improper."

The issuers and borrowers are also hoping DOJ will decide not to take any action against them.

The Bond Buyer

By Lynn Hume and Shelly Sigo

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