Bond Case Briefs

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Conflict of Interest Issues are Pivotal for Municipal Advisors.

Municipal advisors are required to manage carefully, as pivotal issues, conflicts of interest and their disclosure to municipal entity and obligated person clients.

The fiduciary duty of loyalty and MSRB Rule G-17's fair dealing mandate require that conflicts be disclosed and that advisors obtain clients' fully-informed consents to significant conflicts.

The fiduciary duties of municipal advisors arise under both federal and state common law. Dodd-Frank does not override state law. Numerous historical actions have applied state law against non-disclosing advisors.

The MSRB states regarding Rule G-42: "Municipal advisors may be subject to fiduciary … duties under state … laws. Nothing contained in this rule shall be deemed to supersede any more restrictive provision of state … laws applicable to municipal advisory activities."

Under state law, municipal advisors must act solely in their clients' best interests. Tamar Frankel states in *Legal Duties of Fiduciaries*: "The legal duty of loyalty takes two forms. One form is a requirement that fiduciaries act for the sole benefit of the entrustors. The other form is a prohibition on fiduciaries from acting in conflict of interests with the interests of the entrustors." Comment to *Restatement of Agency* §8.01 states: "the general fiduciary principle requires that the agent subordinate the agent's interests to those of the principal and place the principal's interests first as to matters connected with the agency relationship."

Under federal law, the MSRB stated, contrasting municipal advisors with underwriters: "unlike a municipal advisor, the underwriter does not have a fiduciary duty to the issuer under the federal securities laws and is, therefore, not required by federal law to act in the best interests of the issuer without regard to its own financial or other interests …" MSRB Notice 2012-25.

Some advisors may not be sensitive, however, to certain conflicts. This Commentary identifies multiple simultaneous potential conflicts, especially in, but not limited to, certain voted bond issues.

In voted bond issues, it is possible to identify three periods—the pre-election period (when issuers' governing bodies make important decisions), the election period (when voters decide), and the post-election period (when issuers, with professionals, make more detailed decisions and close transactions).

This Commentary, drawn from experience, describes a hypothetical advisor's work.

Contingent Closing Fees

Our hypothetical highly-active advisor has charged contingent closing fees in all of its bond issues for many hundreds of projects.

Contingent closing fees are recognized by many market participants as detrimental to issuers. This fee structure has tended to dominate the discussion of conflicts, although there are other significant advisory conflicts. Some issuers, especially smaller, less sophisticated ones, may be served only by professional teams who will not be paid without a closing. Those issuers may not receive input from a single professional without an eye on closing compensation.

Most bond issues require months of hard work. Risky or difficult issues commonly require additional time. Professionals paid contingent fees place those months of hard work at risk, if they provide advice delaying or discouraging closings. Professionals working directly on bond issues may experience pressures to complete transactions from supervisors or partners. Nevertheless, it may be in issuers' best interests not to close. I have seen numerous examples of imprudent bond issues.

The National Federation of Municipal Analysts' *White Paper on the Disclosure of Potential Conflicts of Interest in Municipal Finance Transactions* states: "Historically, compensation arrangements in municipal finance transactions that hinged on transactional completion have been associated with poorly structured bond issues …, to the detriment of municipal investors, as well as issuers and obligors."

While some may argue that other fee structures also involve conflicts — professionals paid hourly fees may charge additional time — the relative risks to issuers are not identical. The risk to issuers from additional time charged as hourly fees is dwarfed in contrast to potential seven figure costs to issuer from unwise closings.

In my 40-plus years in the municipal market, I found that non-contingent fees tended to be lower than contingent fees. Indeed, the "contingency" often is cited as a risk by professionals in justifying higher fees. Our advisor does not disclose this information.

Further, additional time charged as hourly fees may be exactly what is necessary for extra care that protects issuers—time that advisors paid contingent fees may avoid to minimize their own costs and delays.

The Government Finance Officers Association's *Best Practice—Selecting and Managing Municipal Advisors* discourages the payment of contingent fees, stating a preference for non-contingent fees "to remove the potential incentive for the municipal advisor to provide advice that might unnecessarily lead to the issuance of bonds."

GFOA opines that "this may be difficult given the financial constraints of many issuers." GFOA adds, however, that issuers paying contingent fees should "undertake ongoing due diligence to ensure that the financing plan remains appropriate for the issuer's needs." GFOA does not indicate how tens of thousands of small, unsophisticated issuers heavily dependent upon their municipal advisors are able to discharge additional oversight responsibility effectively.

Non-contingent fees are rarely burdensome. Even financially-limited issuers routinely pay non-contingent fees to a wide variety of professionals. In completed transactions, non-contingent fees are recoverable from bond proceeds. Moreover, if financially-limited issuers pay non-contingent fees in uncompleted transactions, it may be for the best advice issuers possibly could have received.

In practice, some advisors act directly counter to GFOA's expressed opposition to contingent fees. What GFOA presents as an exception to the general rule of avoiding contingent fees instead is applied by some advisors on a vastly broader basis, destroying issuer choice. Those municipal advisors charge contingent closing fees in every bond issue and never offer issuers fee alternatives.

Our hypothetical advisor always proposes contingent fees to issuers without disclosing risks, without offering alternative fees, without informing issuers of the pros and cons of alternative fees, without informing issuers that non-contingent fees are recoverable from bond proceeds, and without obtaining issuer consents. Yet, our advisor advertises itself misleadingly as "independent." NFMA states: "Contingent compensation is especially undesirable for … for municipal advisors … who are expected to be independent in the provision of advice …"

Consequently, some issuers have never been offered non-contingent fees and have never received disclosure identifying fee alternatives or relative merits.

Unfortunately, the additional burden the conflicts place upon issuers severely weakens the issuers' important intended Dodd-Frank Act protections.

Notably, Tamar Frankel states: "When fiduciaries wish to engage in conflict of interest transactions and seek their entrustors' consent, the entrustors must fend for themselves. Their right to rely on their fiduciaries must be eliminated. In fact, during the bargaining, the entire fiduciary relationship must be terminated and replaced by the relationship of contract." Our advisor does not disclose this information.

Multiple Contingent Closing Fees

A related conflict is that, during the pre-election period, our hypothetical advisor encourages an issuer's board to propose to voters a tax-supported bond plan that cannot be executed completely on the basis of existing property values and estimated tax rates. The advisor encourages the issuer to add projects extending beyond the issuer's immediate intentions. The recommended plan relies in part upon a second future issuance assuming property values inflate.

Our hypothetical advisor anticipates multiple closings and multiple contingent fees pursuant to its recommended bond plan. Work on a future issue will duplicate much of the disclosure and bond documentation. Hourly fees would be based only on actual time.

Fees Contingent on Board Action and Election Results

Our hypothetical advisor describes the pre-election period as the "marketing phase."

The advisor charges, in the pre-election period, a fee contingent upon approval by the issuer's board of the advisor's recommended bond plan and upon voter bond authorization. This contingent fee motivates the advisor to promote bond issuance.

Our advisor assures the issuer's board that the advisor's recommended bond plan for multiple bond issues refunding outstanding obligations and funding additional projects is based upon "conservative" modeling. Actually, the advisor does not (and lacks skills to) prepare financial analysis supporting the recommendation. Ultimately, the advisor's recommended tax rate and bond principal prove inadequate even to refund the issuer's outstanding obligations.

Election Consulting Conflicts

Our advisor anticipates that favorable bond election results will lead to the hypothetical advisor's collection of its pre-election contingent fee and of multiple post-election contingent fees.

The advisor works on the bond election pursuant to an election committee contract for a fee drastically below the advisor's typical compensation. The advisor sends multiple officers to a distant community for several days to work in the bond election for a hypothetical fee and reimbursement of

$1,500, while anticipating receipt of aggregate contingent compensation of $160,000.

In effect, our hypothetical advisor works on the bond election as an undisclosed "loss leader."

To recover its losses, the advisor must convince voters to authorize the bonds. In our hypothetical, taxpayer advocates supporting bond issuance object to assertions in campaign literature prepared by the advisor and threaten to withdraw support until retraction.

Dependence on Underwriters

Our hypothetical advisor not only cannot prepare bond structuring analyses, but depends on underwriters to do so—a serious conflict. This is why our advisor recommends negotiated bond issues even for highly-rated commoditized bonds with a common security structure.

Assistance by the advisor in the underwriters' retention enhances the conflict's severity, as does the advisor's negotiations on behalf of the issuer with the underwriters of compensation, bond terms, and yields—an agency role.

Disclosure and Consents

Requirements for disclosure of conflicts and for obtaining client consents arise under MSRB Rules G-42 and G-17, as well as the Dodd-Frank Act's statutory fiduciary duty and state common law.

MSRB Rule G-42(b) requires disclosure of municipal advisor conflicts arising from certain relationships, stating: "A municipal advisor must… provide to the municipal entity or obligated person client full and fair disclosure in writing of: … "(E) any conflicts of interest arising from compensation for municipal advisory activities to be performed that is contingent on the size or closing of any transaction …; and (F) any other actual or potential conflicts of interest, of which the municipal advisor is aware after reasonable inquiry, that could reasonably be anticipated to impair the municipal advisor's ability to provide advice .. ."

In Supplementary Material, Rule G-42 provides that "Disclosures of conflicts of interest by a municipal advisor to its municipal entity or obligated person client must be sufficiently detailed to inform the client of the nature, implications and potential consequences of each conflict."

Describing state law, Tamar Frankel states: "Fiduciaries must provide … material information necessary for the entrustors to make an informed decision. … In reality, entrustors can seldom perform [a cost-benefit] analysis because they lack accurate information … ," adding "the burden of proving" fairness and reasonableness "is usually on the fiduciaries."

Tax regulations

The Restatement of Agency §8.06, speaks to how agents, such as municipal advisors, are able to obtain effective state law consents. Agents must "act[] in good faith," "disclose[] all material facts that the agent knows, has reason to know, or should know would reasonably affect the principal's judgment," and "otherwise deal[] fairly." The Restatement adds that the agent has the burden of proving informed consent.

Conclusion

Municipal advisors to municipal entities and obligated persons may be subject simultaneously to multiple conflicts of interest that should be fully disclosed, with client consents, under both federal and state law. It is essential for advisors to be sensitive to these significant issues.

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