Bond Case Briefs

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Mintz Levin: SEC Steps Up Scrutiny of Municipal Bonds: Recently Filed Enforcement Actions.

As discussed last week, the SEC has been stepping up its scrutiny of **municipal bond offerings**. Indeed, in the last year the **SEC** has filed a number of enforcement actions against **municipal bond issuers** and underwriters. The alleged violations have involved misstatements or omissions concerning such topics as: compliance with tax exemption requirements or reporting requirements; limitations on debt capacity; property valuations; and municipal accounts.

In particular, in announcing its **Municipalities Continuing Disclosure Cooperation Initiative**, which encourages municipal issuers and underwriters to self-report possible disclosure violations (as discussed in more detail in Bret's post), the SEC specifically noted that it may file enforcement actions against issuers for inaccurately stating in final official statements that they have substantially complied with their prior continuing disclosure obligations. Underwriters may also be charged with securities violations if they have failed to exercise adequate due diligence in determining whether issuers have complied with such obligations. The SEC cited the *West Clark Community Schools*case discussed below as an example of such an enforcement action.

Notably, in many of these recent enforcement actions the SEC has asserted claims for merely negligent violations of Sections 17(a)(2) and (3) of the Securities Act, instead of, or in addition to, claims for violations of Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5, which require proof of knowing or reckless misconduct. In some court cases the SEC has also successfully argued that the alleged knowledge of an employee or agent may be attributed to the bond issuer for purposes of pleading that the issuer acted with the requisite "scienter" to support a 10b-5 charge. Thus these cases raise a concern that even relatively "innocent" mistakes may lead to SEC charges.

While the issuer was actually fined in only one of these cases, the SEC has also required issuers to provide training for personnel or to hire consultants to review disclosure practices and procedures as a condition of settlement. Meanwhile, underwriters have often faced more substantial financial penalties. Some particular examples are discussed further below. More than ever, these cases illustrate how important it is for government entities and underwriters to obtain careful counsel about potential pitfalls in bond offerings.

- ***In re the Greater Wenatchee Regional Events Center Public Facilities District.*** As we discussed in an earlier post, last November the SEC announced that, for the first time in its history, it had fined a municipal bond issuer for making misleading statements in an offering statement. The case involved a municipal corporation formed to fund development of a regional multi-use arena and hockey rink in the city of Wenatchee, Washington. The SEC found that the official statement for bond anticipation notes issued to fund the project failed to inform investors about debt capacity limitations and an adverse feasibility study. The SEC brought administrative claims against the issuer and others for negligent violations of Sections 17(a)(2) and (3). The SEC assessed fines of $20,000 against the issuer and $10,000 each against the project developer and its CEO, as well as $300,000 against the underwriter and $25,000 against the lead investment banker.
- ***SEC v. City of Victorville.*** To finance redevelopment of a former Air Force base, the City of

Victorville, California, created a development authority that issued tax increment municipal bonds. The SEC alleged that the tax increment figures and debt service ratio in the offering statement for one of these bond offerings were based on a false assessment of the value of redeveloped airplane hangars at the base. The SEC filed suit in federal district court against the city, the authority, the authority executive director, the city's director of economic development, the bond underwriter, and its principals, asserting claims for violations of Rule 10b-5 and Section 17(a) and aiding and abetting. The court denied the defendants' motion to dismiss last November, and the case is currently in discovery. Notably, in denying the authority's motion to dismiss, the court accepted the SEC's argument that the alleged knowledge of the city's economic development director that the value of the hangars was overstated should also be attributed to the authority, because he was the authority's agent for the content of the bond offering statement. *See SEC v. City of Victorville*, No. ED CV13-00776 JAK (DTBx), 2013 U.S. Dist. LEXIS 164530 (C.D. Cal. Nov. 14, 2013).

- ***In re West Clark Community Schools.*** In July 2013 the SEC charged an Indiana school district and its municipal bond underwriter with falsely representing to bond investors that the school district was in compliance with its obligations under previous bond offerings, even though it had failed to file required annual financial information and notices. In settling these charges, the SEC required the school district to adopt enhanced disclosure and compliance policies and procedures and to provide annual training for personnel involved in the bond offering and disclosure process. The SEC also required the underwriter to pay approximately $580,000 in disgorgement and penalties for its failure to conduct adequate due diligence and providing improper gifts and gratuities to municipal issuers. As noted above, the SEC has cited this case as an example of its readiness to bring enforcement actions concerning inaccurate statements about compliance with disclosure obligations.
- ***SEC v. City of Miami.*** In this well-publicized case, the SEC charged the City of Miami and its former budget director with securities fraud and negligence, alleging that they had misled the investing public about certain interfund transfers from the city's capital improvement fund to its general fund in connection with municipal bonds issued in 2009. The SEC alleged that the transfers were undertaken to conceal deficits in the city's general fund, without disclosing that the transfers involved restricted funds that were dedicated to specific capital projects. The SEC's complaint also charged the city with violating a 2003 SEC Cease-and-Desist Order based on earlier misconduct. A federal district court in Miami denied the defendants' motions to dismiss the SEC suit in December. As in the *Victorville* case, the court held that the alleged knowledge of the city's budget director (whom the city characterized as a "low-level employee") should be attributed to the city itself. *See SEC v. City of Miami*, No. 13-22600-CIV-ALTONAGA, 2013 U.S. Dist. LEXIS 180704, 2013 WL 6842072 (S.D. Fla. Dec. 27, 2013).
- ***In re the City of South Miami, Florida.*** In addition to its action against Miami, the SEC also instituted proceedings in an entirely separate matter against the neighboring city of South Miami. South Miami obtained tax-exempt conduit bond financing through the Florida Municipal Loan Council (FMLC) for a mixed-use retail and parking structure in its downtown commercial district. However, according to the SEC, the city failed to disclose that it had jeopardized the tax-exempt status of the bonds by loaning proceeds from an earlier bond offering to the developer and restructuring a related lease agreement. The SEC also found that the city misrepresented that it was in compliance with the tax-exemption requirements of its loan agreement with the FMLC. After the city settled related tax issues with the IRS, the SEC instituted administrative proceedings against the city. To settle the SEC proceeding, the city agreed to retain an independent consultant for three years to review its policies and procedures regarding its municipal securities disclosures, and to implement the consultant's recommendations.

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