Bond Case Briefs

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He Made $3.8 Million in Fees in an Odd Little Corner of the Muni Bond Market.

From a white ranch house in the Florida Panhandle, Ed Gray presides over a municipal-bond money machine.
The former mayor of the city of Gulf Breeze has turned the riskiest segment of the municipal-bond market into a boon for the Pensacola suburb, which has built recreation centers and boosted reserves with $11 million in fees charged on bond sales and loans since 2002. The payments also benefited Gray: He was paid $3.8 million to arrange the deals.

Capital Trust Agency, a unit set up by the city in 1999 and run by Gray, has issued more than $1.5 billion in tax-exempt debt for apartment complexes and assisted-living facilities around Florida, private jet facilities in Texas and Mississippi, and Hard Rock hotels for the Seminole Indian tribe.

Called conduits, public agencies like Capital Trust operate in a little-regulated corner of the $3.6 trillion municipal market. They issue bonds for private companies and nonprofit organizations that would otherwise lack access to tax-exempt borrowing. Local taxpayers benefit from the fees without being on the hook to repay the bonds, which are often used for risky real-estate projects.

"You have local debt being issued without adequate oversight," said Christopher "Kit" Taylor, former executive director of the Municipal Securities Rulemaking Board, the industry's regulator. "The state should never be permitting this sort of thing."

More Defaults

Conduit bonds make up as much as 30 percent of the market but account for almost 60 percent of defaults, according to Matt Fabian, a partner at Concord, Massachusetts-based Municipal Market Analytics. The U.S. Securities & Exchange Commission in 2012, noting the default rate, sought to require conduit borrowers to disclose more about their finances. The proposal failed to advance in Congress.

All 50 states have conduit issuers, according to the Columbus, Ohio-based Council of Development Finance Agencies, a trade group. Florida is one of seven that allow some conduits to issue debt for out-of-state projects, according to the CDFA.

In December, Phoenix's Industrial Development Authority sold $107.4 million in tax-exempt bonds for school facilities in Guam, more than 6,000 miles (9,700 kilometers) away. The Phoenix agency received $101,177, which will go toward small-business and community-lending programs, according to Lydia Lee, an administrator. The bonds were rated B+, four levels below investment grade.

IRS Cap

Under Internal Revenue Service regulations, private entities can issue tax-exempt bonds as long as they meet public purposes. The federal government sets a limit on the amount of tax-exempt debt issued on behalf of private entities, giving each state an allocation based on population. This year, the total cap is $35.2 billion, according to the Bond Buyer.

Investors are aware that debt issued by conduits carries more risk than bonds backed by the taxing power of state and local governments, and the securities are priced accordingly, said Jason Rittenberg, director of research at the CDFA. Deals are vetted by lawyers to ensure that they comply with IRS rules, and by banks underwriting the bonds, he said.

“It’s a different borrower class,” Rittenberg said. “These deals are required to be sold to investors aware of how the market operates.”

Gulf Breeze Story

Gulf Breeze sits on a land spit that juts into Pensacola Bay, 680 miles northwest of Miami. The affluent suburb of 5,800 is known for its beaches, including the Gulf Islands National Seashore.

The City Council created the Capital Trust Agency with the town of Century, under a Florida statute that allows two or more counties or municipalities to jointly issue debt.

The city hired Gray’s firm, Municipal Advisory Services, to run Capital Trust, which has two other employees in the city-owned ranch house, an analyst and administrative assistant. Mayor Matt Dannheisser, who was then city attorney, was its lawyer, and the city manager worked as a paid consultant.

Capital Trust attracted borrowers by charging lower fees than other conduits and by being more efficient, Dannheisser said. The agency also issued bonds for air-cargo facilities and charter schools.

Since 2002, Capital Trust and another financing arm, Gulf Breeze Financial Services, contributed an average of $850,000 annually to the city budget, equal to about 50 percent of annual property-tax collections. A developer contributed $500,000 from the sale of an apartment complex whose purchase was financed by Capital Trust to scholarships for low-income students in the Pensacola area.

IRS Scrutiny

About $81 million of debt issued through the agency, about 5 percent, has defaulted, according to data compiled by Bloomberg. The rating on an additional $50 million of bonds issued for Million Air Inc., a Houston-based jetport operator, was cut in December to B3, six levels below investment grade, by Moody’s Investors Service. Investors may declare the bonds in default, the rating company said.

In 2010, officials in Lauderhill, Florida, declared unsafe for residents a 352-unit apartment complex whose purchase was financed by Capital Trust, according to the Florida Sun-Sentinel. Another property in Tampa had “numerous” fire code violations, according to the Tampa Tribune.

Capital Trust deals have also drawn scrutiny from the IRS, which looks into whether the tax exemption is being misused. In 2007, Capital Trust settled an IRS audit of $410 million of bonds sold from 2002 through 2004 to finance Hard Rock hotels at two Seminole casinos.

The IRS said the bonds shouldn’t have been tax-exempt because the hotel and convention center weren’t used “in the exercise of an essential governmental function.” Capital Trust paid $100,000 to settle the case while others in the deal, who weren’t identified, paid $10 million, according to a Capital Trust financial statement.

Gary Bitner, a spokesman for the Seminoles, said he couldn't immediately respond to what amount, if any, the tribe paid to the IRS.

Stopped Payments

In 2004, Capital Trust settled with the IRS over a $220 million bond issued to refurbish derelict apartments, which produced $12 million in fees for banks and advisers even though the proceeds were never spent.

"Examinations by the IRS of selected project financings have never resulted in the bonds being declared taxable," Gray said in an e-mail. "We have always cooperated with regulatory agencies in concert with the borrowers to properly answer inquiries and reach satisfactory settlement on any tax questions raised."

Last year, city officials discovered that in 2006 Gray had stopped making required annual reimbursements to the city. Gray, 63, who was elected mayor in 1984 and retired in 1992, said it was an oversight and repaid $122,250.

The lapse led Gulf Breeze officials to bring in an outside auditor to review his compensation. Based on the auditor's interpretation of his contracts, Gray's pay since October 2002 should have been $500,000 less.

Incentive-Based

"I've been quite satisfied with compensation," Gray said in a telephone interview. "The contract is incentive-based. I didn't get paid if we didn't have success."

He said the auditor misinterpreted contract language. City management and Capital Trust's board always approved his pay, he said. Dannheisser, the mayor, declined to comment on whether Gray was overpaid, citing Florida rules regulating attorneys.

Dannheisser made about $627,000 serving as counsel on Capital Trust deals from 1999 through 2014, according to bond-closing documents obtained under a public-records request.

The city last week approved a new contract for Gray, though it lowered his pay.

Joseph Henderson, the mayor pro tem, hasn't been able to assemble a majority of council members to recoup money from Gray.

"Sometimes we think there are individuals within this city that are too big to fail, and that's unfortunate," Henderson said.

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by Martin Z Braun

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