Bond Case Briefs

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Municipal VRDO Class Action Survives Banks' Request for Dismissal.

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On November 2, the United States District Court for the Southern District of New York (SDNY) largely denied a motion to dismiss a class action lawsuit brought by the cities of Philadelphia and Baltimore (collectively, the Plaintiffs) in May 2019. The Plaintiffs brought the action on behalf of themselves as well as other municipal issuers of variable rate demand obligations (VRDOs) against several large banks (the Banks). Plaintiffs allege that beginning in April 2009 and continuing through November 2015 (the Class Period), these banks collectively forced state and local governments to pay inflated interest rates on the bonds and notes issued as VRDOs in derogation of the Sherman and Clayton Antitrust Acts, as well as various state laws. The Banks deny the allegations and claim that they are baseless.

Judge Jesse M. Furman ruled that the Federal antitrust claims, as well as some of the state law claims, could continue.

Background

Publicly-Financed Projects

At issue in the lawsuit are the Banks' alleged improper remarketing practices in connection with bonds and notes issued by state and local governmental entities, as well as other public agencies and authorities. Issuers use these bonds/notes to finance projects including, but not limited to, economic development, education, hospitals, housing, transportation, and utilities.

Public Support

Certain VRDO bonds and notes are secured by tax revenues – generally, corporate and personal income taxes, sales taxes, and property taxes from individual and corporate taxpayers in the respective jurisdictions.[1] Other VRDOs are secured by revenues generated from a particular community project being financed. Some such examples include: (i) tenant rents for affordable housing, (ii) medical charges for hospitals, (iii) mortgage payments for single family housing, (iv) utility payments for electric, water, and sewer systems, (v) landing fees/passenger ticket charges for airports, (vi) tolls for bridges and highways, (vii) fares for mass transit, (viii) tuition for colleges and universities, (ix) property taxes for K-12 education, and (x) assorted local taxes and user fees for libraries, government buildings, police and fire stations, and parks.

To incentivize projects with a valuable community purpose, the Federal government provides a tax exemption on the bonds/notes to investors. For a project to qualify for the exemption, the Internal Revenue Code requires that for-profit companies have a limited role in these financed projects. Notably, unlike most other bond markets, there is an even split between corporate investors and

individual investors of municipal bonds/notes as individual investors benefit from the Federal (as well as state and local) tax-exemptions, are often utilized for an individual's retirement savings and, importantly, provides monies to build and maintain beneficial projects to the community at large.

VRDO Structure

General

VRDO bonds are issued on a long-term basis but have short-term interest rates that reset on a periodic basis, typically weekly. Accordingly, VRDOs are very attractive for governmental entities as they can borrow long-term at generally lower short-term rates. VRDOs also offer flexibility to investors, who can exit the investment on a weekly basis through a remarketing agent. Here, remarketing agents are required to remarket the bonds to other investors. Alternatively, if there are no investors willing to purchase the VRDOs, the bonds are 'put' back to a rated bank. Both the remarketing agent and the bank providing liquidity (the Liquidity Bank), which are typically the same or affiliated entities, charge fees for their services. These fees must be added to the favorable interest rates to obtain the true cost of the borrowings to the governmental entities.

Interest Rate Swaps

Even though governmental entities (and their taxpayers) appreciate low interest rates, governmental entities generally are averse to variable rate risk, which can increase or decrease on a weekly basis. For this same reason, many homeowners do not like having adjustable rate mortgages, especially in a low fixed-rate environment. Accordingly, to assure that interest rates do not fluctuate, the Banks often provide parallel interest rate swaps so that the governmental entities take limited interest rate risk while the Banks take the variable rate risk.

However, there are numerous risks associated with swaps. These risks include, but are not limited to, basis risk, counterparty risk, and termination risk. Generally, governmental entities are not familiar with many of these risks. And these risks are often not fully explained by the Banks themselves. In general, in a falling interest rate environment (such as what has been occurring since the Great Recession, and exacerbated by the pandemic), interest rate swaps can be a significant drain on the resources of governmental entities. Additionally, conspiracies to manipulate interest rates (as allegedly occurred in this dispute) are the frequent subject of many of the cases cited by this court. Indeed, in resolving this motion, the court relied on several prior cases that involve Banks and other market participants manipulating interest rate swaps and other financial/commodity markets.[2]

Although the court discusses testimony from a Bank insider that VRDOs are a relatively low margin product for the Banks, interest rate swaps have historically been a very high margin product for banks offering swaps. Indeed, interest rate swaps have historically generated a significant percentage of large bank profits. For that very reason, such banks often encourage governmental entities to tie VRDOs to swaps. By this arrangement, the banks gain tremendous profits (and resultant banker bonuses), while the government reduces its perceived risks associated with VRDOs instead of undertaking a straight fixed rate bond deal or a VRDO with an interest rate cap.[3]

Remarketing Agent Role

In most remarketing agreements, the banks have two primary obligations. First, they must reset the VRDOs weekly interest rate at the *lowest possible rate* that would permit the bond to trade at par. Second, as mentioned above, the banks must remarket the VRDOs to other investors at the *lowest possible rate* when existing investors decide to exit the investment. Remarketing agreements can

also generally be terminated by the governmental entities at will. If, for example, a governmental entity is not satisfied with a bank's remarketing efforts, then the governmental entity might want to replace the bank with another remarketing agent.

Liquidity Bank Role

If the banks, as remarketing agents, are unable to find another investor, the Liquidity Banks are required to purchase the tendered, but unremarketed, bonds. This contractual obligation between the banks, as Liquidity Banks, and the governmental entities is typically called a letter of credit and reimbursement agreement. The interest rate for a tendered, un-remarketed, bond that is held by the Liquidity Bank typically ranges from 10-15%, a significant increase from the low current 1-3% interest rate on VRDO bonds. Notwithstanding this high rate, Liquidity Banks prefer not to hold un-remarketed bonds, as doing so typically indicates that the transaction has some sort of underlying issue.

Importantly, a bond with a drawn letter of credit would require that additional capital be set aside by the Liquidity Bank. In essence, this un-remarketed bond would then, generally, be characterized as a defaulted bond by the Liquidity Bank. Banks try to avoid this situation at all costs.

Market Disruptions

Lehman Brothers' bankruptcy filing in September 2009 caused tremendous upheavals in the VRDO market. In 2008, $116.3 billion of VRDO bonds were issued by municipal issuers.[4] In contrast, in 2009, $32.3 billion of VRDO bonds were issued by these issuers, a decrease of 72%. [5] This general decreasing trend continued in each subsequent year of the Class Period. [6] One reason for these significant decreases was the failure of many banks to maintain satisfactory credit ratings. The decline in the banks' credit ratings forced governmental issuers to pay the un-remarketed bond rate of 10-15%, causing significant financial strains on government resources.

As these upheavals occurred in the midst of the housing crisis, Arent Fox was brought in to help develop the Temporary Credit and Liquidity Program (TCLP) with the US Department of Treasury, the Federal Housing Finance Agency, Fannie Mae and Freddie Mac, and state housing finance agencies throughout the country. This $8 billion program replaced the Liquidity Banks' liquidity facilities with facilities jointly provided by Freddie Mac and Fannie Mae.

State and local housing finance agencies are tasked with supporting affordable housing. This task became difficult (if not impossible) due to, among other things, the parallel banking crisis, which required these housing finance agencies to devote their limited resources to pay much higher interest rates on their VRDO bonds rather than developing new affordable housing and supporting existing housing projects. This prompted the creation of TCLP, along with a program to facilitate the issuance of new bonds during this crisis period – the $16 billion New Issue Bond Program (NIBP), which the Firm also helped develop and implement. Although the TCLP program was scheduled to terminate in 2012, it was extended through 2015, the end of the Class Period. The primary reason for an extension was that the Liquidity Banks were reluctant to provide liquidity during this tumultuous period for certain governmental issuers.

Alleged Antitrust Conspiracy

As alleged in the Class Action Complaint, the Banks, which served as remarketing agents for approximately seventy-five percent of all VRDOs issued in the United States, conspired not to compete against each other.

Philadelphia and Baltimore claimed that the Banks shared information regarding proprietary information, such as VRDO Bank inventory levels and planned changes to the VRDOs' base interest rates, in an effort to keep interest rates on VRDOs artificially high. According to the Complaint, collusion existed at all levels across each bank, ranging from senior personnel in Municipal Securities Groups, to the remarketing desks below these groups, down to sales desk personnel. [7]

As detailed in the Complaint, agents of the Banks communicated regularly, frequently, and in great detail. They often shared confidential and sensitive information relating to the VRDO issues. In some instances, the Banks are alleged to have shared the specific rates they were planning to set.

Ultimately, a related whistleblower complaint was filed, which led to the Securities Exchange Commission (SEC) opening a formal investigation in November 2015, and the Department of Justice (DOJ) starting its own investigation in 2016.

SDNY Rulings

Antitrust Claims

The bulk of the court's decision dealt with the Federal antitrust claims, which were ultimately upheld. The court stated that, during the Class Period, there was a plausible argument that the Banks "conspired *not* to compete against each other in the market for remarketing services." Needless to say, this type of alleged anticompetitive behavior is precisely the type of conduct contemplated and prohibited by the Clayton Act and the Sherman Act more than 100 years ago.

Rate Manipulation

In setting the initial rate, weekly rate resettings, and the rate upon tender of VRDOs, the Banks are supposed to consider the individual characteristics of the bonds (*e.g.,* issuer financial strength, security, Liquidity Bank credit rating), market conditions and investor demand, rather than Bank inventory levels or profits.

Here, the court determined that by resetting the VRDO base rates on a regular and arbitrary basis, the Banks had coordinated the rate reset of a large number of VRDOs in violation of the Federal antitrust laws. In fact, Judge Furman found the Banks' conduct to be both "deceptively simple" and "effective," as the interest rates during the Class Period for VRDOs were alleged to be nearly seventy-five percent higher than the rates would have been absent the Banks' conduct. The court also determined that the coordination of interest rates ceased shortly after the SEC and DOJ investigations began. In the court's view, this timing indicated that the Banks had stopped coordinating their illicit rate-setting practices in direct response to the investigations.

Collusive Activities

Although pending investigations may not, standing alone, satisfy an antitrust plaintiff's pleading burden, the court held that government investigations may be used to bolster the plausibility of these claims and allegations of rate manipulation. Thus, the court concluded that there were enough facts in the complaint to survive the motion to dismiss.

The court also found that allegations of Bank misconduct constituted "plus factors" – circumstantial evidence demonstrating, by inference, the existence of a price-fixing conspiracy.[8] For example, the court found that the regular communications and exchange of information between the Banks demonstrated that they were able to (and did) coordinate their rates to ensure that none of the Banks broke ranks from the conspiracy. The court also ruled that each of the Banks had a motive to engage in the alleged scheme.

In addition, the court also determined that that the Banks had used a third-party pricing service (J.J. Kenny Drake Inc.) until 2012 to telegraph to each of the Banks the collective view of where the base rate should settle for the Banks in remarketing bonds.[9]

Accordingly, the court held that Philadelphia and Baltimore had satisfied their burden, and ruled that the antitrust claims could continue against all defendants.

State Law Claims

Breach of Contract

Philadelphia and Baltimore also brought several breach of contract claims against the Banks based on Pennsylvania and Maryland state law. The court determined that several of the Banks had not entered into contracts with either city, served as their remarketing agents, or otherwise had any role at all in facilitating a contractual relationship with the cities. Accordingly, the court granted the motion to dismiss the breach of contract claims as to each of these "Non-Counterparty Banks."

However, the court denied the motion to dismiss as to the remaining Banks that *had* entered valid remarketing agreements with the cities (the "Counterparty Banks"). The court held that Plaintiffs sufficiently pled that these "Counterparty Banks" *had* breached their contracts with Plaintiffs by failing to fulfill a contractual obligation under the remarketing agreements to use their *best efforts* – a high standard in the municipal bond market – to reset the interest rates of the VRDOs based on prevailing market conditions, and to remarket the bonds at the lowest rate possible that would allow the bonds to trade at par.

Breach of Fiduciary Duty

Philadelphia and Baltimore also brought several breach of fiduciary duty claims against the Banks. However, as it had done with the Non-Counterparty Bank breach of contract claims, the court dismissed the fiduciary duty claims against the Non-Counterparty Banks, ruling that they had no fiduciary or confidential relationship with either of the Plaintiffs. The disposition of the remaining fiduciary duty claims varied based on the applicable state law.

Unjust Enrichment

Finally, the Complaint also included claims for unjust enrichment against all of the Banks. The court reasoned that both Pennsylvania and Maryland law required the Plaintiffs alleging unjust enrichment to show that the validity of a contract itself is actually disputed. Here, the court noted that none of the Banks disputed the *validity* of the remarketing agreements. Rather, the dispute involved the *performance* stemming from the contracts. Accordingly, the court ruled that the unjust enrichment claims against the Counterparty Banks, which were duplicative of the breach of contract claims, must be dismissed.

The court also dismissed the unjust enrichment claims against the Non-Counterparty Banks, holding that both Plaintiffs failed to plausibly allege, as Pennsylvania and Maryland law requires, that these Banks had been enriched at their expense. Rather, as Judge Furman determined, neither Plaintiff had conferred a direct benefit to any Non-Counterparty Bank.

Statute of Limitations

The applicable statute of limitations for the claims brought in this case ranged from two to six years. The statute of limitations is tolled in each relevant jurisdiction where allegations plausibly allege that the Banks concealed their misconduct, and the Plaintiffs' ignorance of the concealed

misconduct was not a product of their own lack of reasonable diligence. Accordingly, the court held that the alleged misconduct conduct was secret and covert by its very nature, and further ruled that a determination of the Plaintiffs' diligence in uncovering this conspiracy was premature at the pleadings stage.[10]

Takeaways

Even though Plaintiffs' lawsuit, as well as the DOJ and SEC investigations, are ongoing, banks and other market participants can already draw certain key lessons from the case. Crucially, the case demonstrates that banks and other financial institutions are vulnerable to Federal antitrust claims based on their conduct in financial markets, especially where (as here) courts consider circumstantial 'plus' factors to infer the existence of price-fixing conspiracies.

Financial Institutions

Accordingly, financial institutions should ensure that they have policies in place that prevent anticompetitive conduct similar to what is alleged to have occurred in this case.

In particular, financial institutions should be mindful of communications with other institutions that could imply horizontal conspiracies. Where necessary, financial institutions should retain outside counsel to develop policies and procedures to prevent or, at a minimum, immediately identify improper conduct *before* it develops into a bank-wide or industry-wide problem.

Additionally, all financial institutions, and particularly those that deal with bonds, swaps and other financial instruments, should be cognizant of the ability of municipalities and corporate borrowers to sue them for contractual breaches where there are plausible breaches of the underlying financing agreements. Here, too, financial institutions should work with outside counsel to ensure that their internal policies and external actions minimize conduct that may violate state and Federal laws and regulations, and incentivize employees to reward high ethical standards.

Governmental Entities and Conduit Borrowers

In addition, as always necessary, governmental entities, as well as conduit borrowers (including corporations and, in particular, not-for-profit corporations), should retain sophisticated, experienced and independent counsel and financial advisors to assure an independent review of VRDOs and the associated derivatives instruments so as to avoid repeating the turmoil impacting these instruments during the Great Recession. This is crucial for all financings, and not just VRDOs.

We can always hope…

[1] Due to the COVID-19 pandemic and resultant economic dislocations, general sales and selective sales taxes have likely been most affected, severely straining the financial wherewithal of municipal issuers. The impact will likely not be completely apparent until the end of such governmental entities' fiscal years (typically June 30th). The ten (10) most affected states, in order of highest percentage of tax revenues from these taxes (ranging from 61.7% to 85.1%), are:

1. Texas 6. Tennessee
2. South Dakota 7. Mississippi
3. Florida 8. Indiana
4. Nevada 9. Ohio
5. Washington State 10. Hawaii

In addition, due to disruptions in the oil and gas industry as a result of the pandemic, related

severance taxes may also be adversely impacted. The states with significant severance taxes, in order of priority highest percentage of tax revenues from these taxes (ranging from 31.7% to 52.5%), are:

1. North Dakota 2. Alaska 3. Wyoming

Source: "Share of tax revenue in the United States by source FY 2019, by state," Statista (June 2020).

[2] In deciding the Banks' motion to dismiss, the court relied on several recent SDNY cases involving interest rates swaps. *See Gelboim v. Bank of Am. Corp., In re Interest Rate Swaps Antitrust Litig.*, 823 F.3d 759 (2d Cir. 2016) (finding that an inter-bank conspiracy was plausibly alleged); *Sonterra Capital Master Fund Ltd. v. Barclays Bank PLC*, 366 F. Supp. 3d 516 (S.D.N.Y. 2018) (denying a motion to dismiss where defendants allegedly colluded to share information, coordinate rate submissions, and engaged in manipulative trading practices); *Alaska Electr. Pension Fund v. Bank of Am. Corp.,* 175 F. Supp. 3d 44 (S.D.N.Y. 2016) (relating to manipulation of ISDAfix, a rate recently confirmed with the Federal Reserve Board of St. Louis (FRED), that as best as it can tell, is derived from LIBOR); and *In re LIBOR-Based Fin. Instruments Antitrust Litig.*, 27 F. Supp. 3d 447 (S.D.N.Y. 2014) (dismissing unjust enrichment claims against non-counterparty defendants).

In addition, the court also relied on a separate line of SDNY cases involving other types of market manipulations. *See In re Foreign Exch. Benchmark Rates Antitrust Litig.,* 74 F. Supp. 3d 581 (S.D.N.Y. 2015) (holding that consolidated complaint adequately established antitrust injury); *In re Commodity Exchange, Inc., Gold Futures & Options Trading Litigation*, 328 F. Supp. 3d 217 (S.D.N.Y. 2018) (holding that class failed to state antitrust conspiracy claim); *In re GSE Bonds Antitrust Litig.,* 396 F. Supp. 3d 354 (S.D.N.Y. 2019) (holding that alleged price-fixing conspiracy was inherently self-concealing so as to constitute fraudulent concealment); and *In re Platinum & Palladium Antitrust Litig.,* No. 1:14-CV-9391 (GHW), 2017 WL 1169626 (S.D.N.Y. Mar. 28, 2017) (finding a conspiracy plausibly alleged).

[3] In contrast to a swap which has no up-front cost (though potential substantial costs over time), an interest rate cap has an up-front cost (though with no costs over time) but is often limited to a period shorter than the tenor of the underlying bonds. In deciding between a swap and a cap, the governmental entity will often decide to go with the 'free' product (i.e., a swap). It should be emphasized that most banks do not even volunteer a cap option due to its limited profit potential for the bank (and the banker).

[4] The Bond Buyer.

[5] Id.

[6] Id.

[7] Parallel allegations against banks and other institutions were made in the SDNY cases referenced by the court in Footnote 2 above.

[8] *See Bell Atl. Corp. v. Twombly,* 550 U.S. 544, 556 (2007).

[9] This is consistent with many of the SDNY cases referenced in Footnote 2 above.

[10] Here, the court also ruled that, at the pleading stage, discovery would be appropriate for the parties to develop their claims and defenses. *See In re Issuer Plaintiff Initial Pub. Offering Antitrust Litig.*, No. 00-CV-7804 (LMM), 2004 WL 487222, at *4 (S.D.N.Y. Mar. 12, 2004) (denying motion to

dismiss where relevant statute of limitations had been tolled due to alleged covert rate-fixing conspiracy).

Arent Fox

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