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SEC Charges Texas School District and Former CFO with Fraud Related to Bond: Faegre

On March 16, 2022, the Securities and Exchange Commission charged Crosby (Texas) Independent School District (Crosby) and its former Chief Financial Officer, Carla Merka, with misleading investors in a $20 million municipal bond sale, which was issued to pay down outstanding construction liabilities and fund new construction projects.

The SEC's civil complaint alleges that Crosby failed to disclose $11.7 million in payroll and construction liabilities in connection with the January 2018 sale. The complaint also alleges the school district falsely reported that its general fund had $5.4 million in reserves in its 2017 fiscal year financial statements. According to the Complaint, Merka, who had ultimate authority over Crosby's fiscal year 2017 financial statements and was its highest-ranking executive with financial or accounting experience, was aware that Crosby's financial statements significantly underreported its existing liabilities and that she knowingly included the statements in the bond offering documents. In August 2018, seven months after the bond sale, Crosby's leadership disclosed its financial difficulties. The disclosure led to employee layoffs for the school district and the downgrading of Crosby's bonds.

Crosby's auditor, Shelby Lackey, was also charged with improper professional conduct in connection with an audit of the school district's 2017 financial statements. Specifically, the SEC alleged Lackey violated the Generally Accepted Auditing Standards (GAAS) by failing to obtain adequate evidence to verify Crosby's payroll and construction liabilities, failing to supervise the audit, and failing to exercise professional judgment and maintain professional skepticism.

Crosby consented to the entry of an order to settle the SEC charges on a no-admit, no-deny basis. The order finds that Crosby violated the anti-fraud provisions of the federal securities law. The order cites Crosby's remedial acts and cooperation with the SEC in ordering it to cease and desist from future anti-fraud violations. Lackey also agreed to settle the SEC's charges and consented to the entry of an order that, without admitting or denying any of the findings, suspends her from appearing or practicing before the SEC as an accountant with the right to apply for reinstatement after three (3) years. Merka agreed to pay a $30,000 penalty and to not participate in future municipal securities offerings. In an apparent attempt to highlight her primary role in the false reporting, the SEC effectuated the settlement with Merka through pleadings filed in the civil lawsuit, as opposed to the other parties who were allowed to settle via administrative orders.

This action highlights the SEC's efforts and approach in enforcing securities laws in the context of municipal bond offerings. In 2021, the Division of Examinations stated it would prioritize investments heavily used by retail investors or those that may present elevated risks, including municipal securities. See https://www.sec.gov/news/press-release/2021-39. Those involved in such offerings should consult experienced legal counsel in connection with preparing their offering materials, and particularly in any interaction with the SEC Division of Enforcement, in the event it commences an investigation or enforcement action.

by Michael R. MacPhail, Isaac Smith

March 21, 2022