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Municipal CFOs: Be Careful of Your Bond Disclosures; The SEC is Gunning for You.

The Securities and Exchange Commission (SEC) recently charged two chief financial officers of school districts with misleading investors in municipal bond offerings. This should be a warning to municipal CFOs to be very careful to make appropriate disclosures when involved in their public entities' bond issues. An SEC official recently stated that "the SEC is committed to holding bad actors in municipal securities offerings accountable for their misconduct." Don't be the CFO bad actor that the SEC targets!

Sweetwater (California). The first situation involved Sweetwater Union High School District, near San Diego, California, and its CFO, Karen Michel. The school district issued general obligation bonds in April 2018. In September 2021, the SEC charged that the district and CFO Michel provided inaccurate information in connection with the sale of the 2018 Bonds. The district settled with the SEC and agreed to a consent order. CFO Michel also settled with the SEC, was banned from participating in future municipal bond offerings, and agreed to pay a \$28,000 penalty. The SEC also required the district to engage an outside financial professional (who was not involved in the bond issue) to clean up the district's financial operations.

What went wrong in Sweetwater? Before the district's FY 2017-18 started, the district agreed to 3.75% raises for its employees. CFO Michel failed to include the full cost of the salary increases in the FY 2017-18 budget. The budget projected an ending general fund balance of \$19.5 million. But if the 3.75% increase were factored into the budget, it would have shown an ending general fund balance of NEGATIVE \$7.2 million. Even though internal analyses by her office recognized the problem, CFO Michel took many steps to cover up the actual deficit.

How did the CFO hide the ball in Sweetwater?

CFO Michel was in charge of all aspects of the district's finances. She oversaw the budget process. She prepared all periodic financial reports to the five person school board. And she oversaw the debt issuance process for the district. In addition, in its resolution approving the issuance of \$28 million of general obligation bonds in 2018, the school board authorized CFO Michel to enter into all agreements and sign all documents related to the bonds. And she did so; she negotiated and signed all documents related to the bonds.

Who did the CFO mislead?

- Her school board.
- The State of California. The CFO filed periodic year-to-date budget information with the state that included the false information.
- The rating agency that gave an "A" rating to the bonds.
- The underwriter and other professionals working on the bond issue.
- Through the preliminary and final official statements, the bond purchasers.

To each of these entities, CFO Michel provided inaccurate information and hid the truth. CFO

Michael then signed the closing certificates that said there were no misstatements or material omissions in the official statement. The bonds were issued in April 2018. CFO Michel retired in September 2018. The new CFO figured out the problem quite quickly, as did the auditor working on the FY 2017-18 audit. The rating agency then downgraded the district from "A" to "BBB+" with a negative outlook.

What are the lessons of Sweetwater?

- For CFOs: Don't hide the truth and lie about the financial condition of the issuer. The truth will eventually come out!
- For the school board: Don't give power over all aspects of the finances to one person. Have some sort of checks and balances in the financial operations.
- For bond professionals: When conducting due diligence, be careful to analyze what you are being told, particularly when it comes to projections of future results.

Crosby (Texas). The second situation involved the Crosby Independent School District, near Houston, Texas, and its CFO Carla Merka. The school district issued \$20 million of general obligation bonds in 2018. In 2022, the SEC charged the district, CFO Merka and the district's auditor with providing inaccurate information in connection with the 2018 Bonds. The district settled with the SEC and agreed to a consent order. CFO Merka was fined \$30,000 and is prohibited from participating in future municipal bond offerings. The auditor was suspended from practicing before the SEC for at least three years.

What went wrong in Crosby?

The district's FY 2016-17 financial statements (a) failed to report \$11.7 million in payroll and construction liabilities, and (b) falsely reported \$5.4 million in reserves. CFO Merka was aware of these problems but did not inform the auditor who prepared the FY 2016-17 financial statements. She then provided the FY 2016-17 financial statements to be included in the official statement for the January 2018 Bonds.

Does this case involve Texas high school football?

Yes, it does! The district issued bonds in 2013 to fund various capital projects, including improvements to the football stadium. The district's superintendent became actively involved in the stadium project, and he directed the contractors to perform project enhancements outside the original scope of work. As a result, the stadium project blew through its budget, and \$12 million from the general fund would be needed to finish the stadium (the district did not have \$12 million available in the general fund). CFO Merka convinced the primary contractor to defer payment until the district could undertake a new bond issue.

Did the district then double down?

Yes, it did! As a way of dealing with the \$12 million problem, the district changed its fiscal year end in FY 2016-17 from August 31 to June 30. The district traditionally paid its teachers their annual salaries over the course of 12 months. The auditor assumed the teachers were fully paid for FY2016-17 by June 30, 2017, but the final two months for FY 2016-2017 were still owing and unpaid - that amount was \$3.8 million. CFO Merka did not tell the auditor of this problem.

As with the Sweetwater situation, CFO Merka in Crosby was in total control of the bond process on behalf of the district, and she did not inform the underwriter or the disclosure counsel of the problems of which she was aware.

Things then hit the fan. The bonds were issued in January 2018. Also in January 2018, the football-loving superintendent resigned. In May 2018, CFO Merka resigned and took a CFO job at another

school district. In June 2018, the district's new CFO discovered the problems. In August 2018, the district went public with the problems. In September 2018, one rating agency downgraded the 2018 Bonds from "A1" to "A3" with a negative outlook. A second rating agency also downgraded the 2018 Bonds from "AA-" to "A-" with a negative outlook.

What are the lessons of Crosby?

- Don't let superintendents anywhere near football projects.
- If the superintendent messes up, the CFO should not cover for him. It could cost the CFO \$30,000 and her career.
- An underperforming auditor can cause real problems. The SEC said the auditor failed to "exercise professional judgment" and "maintain professional skepticism."

Obviously, most people reading this article would not make the mistakes that the CFOs in Sweetwater and Crosby made, but these cases are a good reminder that CFOs, public officials and public finance professionals all need to be very careful and diligent to provide full and accurate information when bond issues are being sold to the public.

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June 1, 2022

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