[Bond Case Briefs]

Municipal Finance Law Since 1971

[Profiting From Financings for Charter Schools: SEC Sues Unregistered, Fee-Splitting Municipal Advisor - Norris McLaughlin]

The public education system in the United States has experienced a series of fits and starts since the time of the American Revolution. Although many of the Founders (think Adams, Jefferson, and Madison, for example) were staunch advocates for education, believing that a democratic government requires citizens who are not only literate, but who can understand and assess matters confronting a government "by the People," and support intelligent efforts to resolve problems. That said, there was no national consistency in the availability of schooling, with some communities and/or churches (particularly in New England) offering education to America's young people, funded mainly by the families of those attending classes. The U.S. Constitution lacks any provision mandating education, so the question of government sponsorship for schools remains to this day primarily a state law issue. By the 1830s, American states began to address public education, including requiring some minimum years of school attendance paid for by taxes imposed on residents.

Public education was seen as particularly important in aiding the assimilation of successive waves of immigrants from the 1850s and again at the turn of the century, education being especially important for improving the language skills of newcomers. Building on those experiences and the legal acceptance of public unionism for teachers, America's public schools were seen by many as hampered by conventional thinking, especially in a world confronting the risks of thermo-nuclear war and competition with the Soviet Union. The creation of Advanced Placement courses was a response to those perceived threats. Another was the beginning of a movement, once again in New England and led this time by Ray Budde, to create local schools by contract, or charter, among a group of teachers and a municipality. The expectation was that the resulting schools would be more experimental and progressive. This notion of an "innovative institution" harkened back to educational developments in Ireland in the 1700s, sponsored by the Catholic Church, but not just religious schools.

In America the so-called "Charter School Movement" grew slowly until the late 1980s, when the idea was embraced by Albert Shanker, President of the American Federation of Teachers, who saw an opportunity both to expand the scope and style of schools and to create more jobs for teachers. The first charter school law was passed in the typically progressive State of Minnesota in 1991, followed by New Jersey and Delaware in 1995 and Pennsylvania in 1997. According to one national report, as of 2015 there were over 6700 charter schools in America, enrolling almost 3 million students. Charter schools are publicly funded, but operate independently from local school districts. Funding for their operations depends upon the particulars of state law where the school is located; frequently such schools must first obtain some form of licensure from the state (or a state or local education body), and then function pursuant to a contract with that entity. This arrangement allows charter schools to raise funds by issuing municipal securities, much like a public school, although some of the risks of repayment and the scope of disclosure required vary materially from those in regular public school financings.

As depicted in the 2024 case of the *Securities and Exchange Commission v. Choice Advisors, LLC and Matthias O'Meara*, U.S. District Court for the Southern District of California, Case No.3:21 CV-1669-JO-MSB ("*Choice Advisors*"):

> [Two charter schools] retained Defendants to assist them in the process of issuing municipal bonds so that they could raise money to build new school facilities. … As first-time issuers of municipal bonds, these schools sought Defendants' help in structuring a deal with a bank underwriter to raise the funds at the lowest cost possible… To facilitate the municipal bond offering the borrower selects a bank underwriter to market and sell the bonds to investors. … The borrower negotiates the terms of the municipal bond offering with the underwriter, which typically involves the school paying a "fee," "spread", or "discount" – usually a percentage of the total value of the bond issued – to its bank underwriter in exchange for the bank purchasing the school's bond and "lending" the school money. … After purchasing the bonds from the school, bank underwriters resell these bonds to third-party investors for a profit. … This financing structure essentially enables the school to "borrow" the money needed for building projects or operations by issuing bonds that the schools ultimately repay with interest.

As explained at length in my Sept. 22, 2020 Blog "SEC Focus on Municipal Securities," the regulation of disclosure in the area of municipal securities is (to use my word) "peculiar." Congress, in an attempt to better deal with some of those "peculiarities," in 1975 amended the Securities Exchange Act of 1934 to create a new body, the Municipal Securities Rulemaking Board ("MSRB"), to strengthen the regulation of the structure of the municipal securities market and of the participants in that market. The MSRB is subject to SEC oversight. Then in 2010, in the Dodd-Frank Wall Street Reform and Consumer Protection Act, Congress expanded the scope of the MSRB to require registration of municipal securities advisors. As the Court said in *Choice Advisors*:

> The municipal advisor's role in …complex financial transactions [like the ones described in *Choice Advisors*] is to act as the school's "skilled representative in the bond offering transaction" and help it negotiate favorable financial terms in the school's best interest.

I wrote about the role of municipal securities advisors in my Sept. 29, 2020 Blog "What if the Advice is Suspect?" In *Choice Advisors*, the Court was presented with a classic case of abuses of that role. In that case, the investigation of these abuses was conducted by a special part of the SEC's Division of Enforcement, the Public Finance Abuse Unit. As I explained in my June 27, 2022 Blog "Serving the Public," the Public Finance Abuse Unit was created in 2010 to provide a more systematic and unified approach to dealing with the increasing incidence of significant neglect of professional obligations and downright fraud in the municipal securities market.

The "bank underwriter" involved in *Choice Advisors* was BB&T, originally named Branch Bank & Trust, founded in 1872 by Alpheus Branch. Over the years, it grew from its North Carolina roots to become, by 2018, a major regional bank with operations all across the country. Two key employees in BB&T's investment banking subsidiary were Matthias O'Meara of Denver, Colorado, and Paula Permenter of Houston, Texas. In 2019, BB&T merged with SunTrust Bank of Florida to form Truist, the 9th largest American bank, with assets of $514 billion. According to the *Choice Advisors* Court, "O'Meara worked as an underwriter at investment bank BB&T" … "[b]efore becoming a municipal advisor for schools and school districts." Because O'Meara was fundamentally a salesman for the underwriting services of BB&T, he "became acquainted with various schools" including future

Choice Advisors clients Bella Mente of Vista, California, and Liberty Tree of Colorado Springs, Colorado. Sometime in January or February 2018, "O'Meara and another BB&T employee, Paula Permenter, decided to leave their jobs at BB&T to start" Choice Advisors. On May 1, 2018, O'Meara resigned from BB&T, giving two weeks' notice. Permenter followed suit.

During the two-week notice period, O'Meara negotiated a deal with BB&T concerning Bella Mente and Liberty Tree, as well as three other California schools identified by O'Meara (so long as the schools selected BB&T as their respective underwriter). The deal was to split the 2% underwriter fee with BB&T: BB&T to get ¾ of the fee, and O'Meara's firm to be formed, Choice Advisors, LLC, to get ¼ of the fee. For example, the $20 fee on a $1 million bond would be divided $15 to BB&T, and $5 to Choice. Choice Advisors, LLC, registered with the SEC as an investment advisor on Aug. 27, 2018,and registered with the MSRB as a municipal securities advisor on Oct. 16, 2018. On May 8, 2018, O'Meara sent Bella Mente an engagement letter to serve as its municipal securities advisor. However, the letter failed to disclose to the school that i) he was still employed by BB&T; and ii) the fee splitting agreement, including the fact that it might pose a conflict of interest for Choice. Similarly, on May 14, 2018, O'Meara's second to last day with BB&T, he sent a parallel engagement letter to Liberty Tree. Both letters stated that:

> [There existed] no known actual or potential material conflicts that might impair [Choice's] ability to render unbiased or competent advice or fulfill its fiduciary duty… And there are "no Other Engagements or Relationships Impairing [Choice's] Ability to Provide Advice.

In addition, the Defendants **completed** the two bond offerings "on the schools' behalf" and received payment for their services **before** they were registered. Choice was paid $157,000 by Bella Mente (on July 11, 2018) and $53, 437.50 by Liberty Tree (on Sept. 21, 2018). Given these facts, the SEC sued Choice on the following grounds:

1. Performing municipal advisory service without being registered;
2. Agreeing to split fees with BB&T;
3. "Deceptively operating in a dual capacity" as both a BB&T underwriter and a municipal securities advisor; and
4. Failing to disclose material conflicts of interest.

It should be emphasized that the two principals of Choice were experienced participants in financial transactions, including the municipal securities market. O'Meara earned a B.A. in finance from the University of Notre Dame and holds a Series 50 municipal advisor license. Permenter, with her B.A.A. from the University of Houston and M.B.A. from the University of St. Thomas, worked for over 20 years in finance, holding a Series 7,66, 79 and 53 before starting Choice, where she, like O'Meara, holds a Series 50 license. Yet they acted as though either asleep or engaged in fraudulent concealment. It is no wonder that the SEC charged them and Choice with breaching their fiduciary duties to the schools and entering illegal arrangements without even being appropriately registered. Most particularly, the SEC charged the Defendants with violating MSRB Rule G-42, and to the extent they dealt unfairly with their clients and engaged in deceptive practices, violating Rule G-17.

The Court, in an April 22, 2024 decision in *Choice Advisors*, granted Summary Judgment to the SEC for failing to timely register with the SEC and with the MSRB, which in turn was the basis for granting Summary Judgment for committing acts in violation of MSRB Rules. Defendants argued that fee splitting was not prohibited because the terms were agreed to before payment, so the 25% payable to Choice was paid directly and not "split" after receipt by BB&T. The Court, however, granted Summary Judgment against the Defendants on this count, as well as for breach of fiduciary duty, including failure to disclose potential conflicts of interest and the lack of required registration. The Court did not grant Summary Judgment concerning the alleged concealment of the dual employment and fee splitting only because Defendants claimed the schools knew of the Choice arrangements, but reserved for further proceedings on this issue. Finally, Summary Judgment was granted against the Defendants for engaging in "Deceptive, Dishonest, or Unfair Practices" in violation of MSRB Rule G-17.

The Court set Aug. 7, 2024, for the SEC to submit its proposal for the Court order imposing sanctions on Defendants, whose objections were due Aug. 16. Were the two Charter Schools injured by Choice? One cannot be certain, but the appearances suggest that Choice and its principals were in this only for personal profit, and not with any concern about the educational exigencies that make Charter Schools an attractive alternative for parents concerned about the quality of education for their children.

by: Peter D. Hutcheon of Norris McLaughlin P.A. – Business Law Blog

Monday, August 26, 2024