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Issuer's Counsel: Help Avoid Targeting by the SEC in Municipal Bond Offerings

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Issuer's Counsel: Help Avoid Targeting by the SEC in Municipal Bond Offerings

December 9, 2022

Presented by:

Ryan T. Gonder and **David Unkovic**
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A Bond Issue is a Danger Zone

- Purpose of the bond issue: to raise funds for capital projects or refunding existing debt.
- Risk: the issuer wants to take advantage of tax-exempt interest; therefore the Internal Revenue Service is interested.
- Risk: the issuer is offering securities to the public; therefore the Securities and Exchange Commission is interested.
- If the IRS or SEC find problems with the bond issue, they can bring actions against the issuer.
- Risk: a lot of money is involved and therefore shady characters may try to misuse or steal some of the money.



With whom is the issuer interacting in this Danger Zone? And do these actors owe a duty to the issuer, or not?

- Issuer's Board and Staff
- Issuer's Counsel
- Bond Counsel
- Municipal Advisor
- Investment Banker
- Credit Enhancer
- Underwriter
- Swap Counterparty



With whom is the issuer interacting in this Danger Zone? And do these actors owe a duty to the issuer, or not?

- **Issuer's Board and Staff:** since they act for the issuer, they owe a fiduciary duty to the issuer.
- **Issuer's Counsel:** you, as general counsel to the issuer, owe duties of diligence, competence and loyalty to your client. Rules of Professional Conduct.
- **Bond Counsel:** a firm retained by the issuer as a special counsel to assist it with the bond issuance process. You should make sure the bond counsel's engagement letter identifies your issuer as its client, in which case it owes the same duties of diligence, competence and loyalty to the issuer as you do.



More actors and their duties and loyalties

- **Municipal Advisor:** often called financial advisor. Advises the issuer on the financial aspects of the bond issue. Owes a fiduciary duty to the issuer (duty of loyalty and duty of care). MSRB Rule G-42.
- **Investment Banker:** often called the underwriter. Finds purchasers of the bonds and agrees to buy the bonds from the issuer and deliver them to the purchasers. Does NOT have a fiduciary duty to the issuer, only has a lesser “duty of fair dealing”. MSRB Rule G-17. Is therefore an ADVERSE PARTY.
- **Credit Enhancer:** may be a letter of credit bank or a bond insurer. Adds its credit to help the issuer obtain a better interest rate. An ADVERSE PARTY.



More actors and their duties and loyalties

- **Swap Counterparty:** provides an interest rate hedge to the issuer. **DON'T LET YOUR ISSUER ENTER INTO A SWAP UNLESS AN EXPERIENCED BOND COUNSEL AND MUNICIPAL ADVISOR ARE ADVISING THE ISSUER. An ADVERSE PARTY.**
- Counsel to the underwriter, the credit enhancer or the swap counterparty. All of these lawyers represent an adverse party and are therefore **ADVERSE** to the issuer.



SEC on the move against issuers who are bad actors

- In the past few years, the SEC has initiated actions against various municipal bond issuers.
- We will review two such situations:
 - Sweetwater (California)
 - Crosby (Texas)





Sweetwater Union High School District

- The SEC's investigation found materially misleading statements about the district's financial status in connection with the sale of general obligation bonds issued by Sweetwater in 2018.
- Ultimately agreeing to a settlement of the charges in September 2021, Sweetwater was required to engage an outside financial professional (who was not involved in the bond issue) to clean up its financial operations; CFO Michel agreed to a ban from participating in future municipal bond offerings and paid a \$28,000 penalty.





What was the problem in Sweetwater?

- Sweetwater's troubles stemmed from its budget for the 2017-2018 fiscal year. Before the start of the fiscal year, Sweetwater implemented 3.75% raises for its employees. However, CFO Michel failed to include the full cost of the salary increases in the budget.
- The effect of this omission was a projected ending general fund balance of \$19.5 million. If the 3.75% increase had been considered, the projected ending general fund balance would have been \$7.2 million in the red – a net swing of over \$26 million.





Why was the problem not recognized in Sweetwater?

- Even though internal analyses by her office recognized the problem, CFO Michel took many steps to cover up the actual deficit.
- CFO Michel was able to “hide the ball” here because she 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, Sweetwater’s board authorized CFO Michel to enter into all agreements and sign all documents related to the bonds.





What did the SEC conclude in Sweetwater?

- The SEC determined that Michel misled her school board, the State of California, the rating agency, the underwriter and other professionals working on the bond issue, and the bond purchasers.
- Once the truth came out, Sweetwater's credit rating was downgraded from "A" to "BBB+" with a negative outlook.





Crosby Independent School District

- The SEC's investigation of Crosby, near Houston, Texas, also involved allegations of material misstatements by Crosby and its CFO, Carla Merka, about the district's financial status in connection with the sale of general obligation bonds issued by Crosby in 2018.
- Charges Settled – March 2022





What was the problem in Crosby?

- Like Sweetwater, Crosby's problems stemmed from issues with its financial statements. The district failed to report in its 2016-17 financial statements \$11.7 million in payroll and construction liabilities, and also falsely reported \$5.4 million in reserves.
- CFO Merka was aware of these problems but did not inform the auditor who prepared the statements. She then provided the misleading financial statements for inclusion in the official statement for the bonds.





Did the Crosby situation involve Texas high school football?

- Yes, it did! The misstatements related to football.
- Crosby had previously issued bonds in 2013 to fund various capital projects, including improvements to its football stadium, but the cost of the stadium improvements exceeded the budget by a whopping \$12 million!!!
- Why? Because the district's superintendent became actively involved in the stadium project and pushed for additional enhancements outside the original scope of work.





Did the CFO try to cover up the problem?

- Yes, she did!
- The district needed to bring another bond issue to market to cover the deficit, but to deal with the problem in the interim, it engaged in some creative accounting: the district changed its fiscal year end from August 31 to June 30, resulting in a “savings” of \$3.8 million in teacher payroll expenses.
- These savings were nonexistent, however, as they were simply pushed into the next fiscal year; CFO Merka did not inform the district’s auditor that the amount was still outstanding and unpaid.





Did the ugly truth come out?

- Like the CFO in Sweetwater, CFO Merka was in total control of the financial processes for Crosby. She did not inform the professionals working on the 2018 bond deal of the issue.
- But, yes, it did come out!
- CFO Merka and the superintendent resigned shortly after the bonds were issued in January of 2018, and by June, the district's new CFO had discovered the problem and disclosed it to the market later that summer. The bonds that were sold in January were downgraded by the ratings agencies that had previously rated them and assigned negative outlooks.



So what do all these problems have to do with issuer's counsel?

- Even though the other professionals may be more experienced in public finance, *none of them knows the issuer as well as the issuer's counsel.*
- The issuer's counsel handles a wide variety of legal issues and has regular contact with the issuer's public officials and staff.
- Therefore, the issuer's counsel should be attentive to what the issuer's board and staff are doing and assist the issuer in developing policies and procedures to avoid the types of issues seen in Sweetwater and Crosby.



Rules for Issuer's Counsel

- Be Attentive
- Ask Questions
- Encourage Checks and Balances
- Be the Designated Cynic and Tire Kicker
- Ultimate Role: Protect the Issuer!!



Rule Number One for Issuer's Counsel: Be Attentive!

1

- If, during the year, the issuer makes major decisions or takes extraordinary actions – including, for example, approving staff raises, selling property, buying property, undertaking new capital projects, incurring debt, and expending debt proceeds – the issuer's counsel should ask the CFO how these actions will affect the issuer's budget, in particular if they were not budgeted previously.
- The issuer's counsel should ask the same questions of the issuer's auditor with respect to the issuer's financial statements.






Rule Number Two for Issuer's Counsel: Ask Questions!

- When it comes to the bond issue, do not be afraid to ask questions if you do not understand what is going on.
- If you are confused, then your client is probably confused, too.
- Do not take “that’s just the way it is done” as an answer; insist on clear explanations.
- Read through the proposed official statement and speak up if anything looks wrong or if something significant related to your client is not being disclosed.
- Tell the bond counsel and municipal advisor that you expect to be informed of any problems or concerns with the financing.

2

Rule Number Three for Issuer's Counsel: Encourage Checks and Balances!

- 
- In the SEC enforcement actions discussed above, the governing bodies of the issuers had delegated power to a single person (the CFO) over all financial aspects of the issuer's operations.
 - These operations included budgeting; reporting financial matters to the governing body and to state oversight entities; entering into contracts related to the funded projects; and controlling all information given to rating agencies, bond professionals and, ultimately, the bond purchasers.
 - It is never a good idea to place all your eggs in one basket.



Rule Number Three for Issuer's Counsel: Encourage Checks and Balances!

4

- Issuers' governing bodies should take care to set up internal checks-and-balances on the creation and dissemination of financial information.
- If the issuer's staff is so small that one person must do everything, have the governing body designate one of its members (e.g., the Treasurer) to keep an eye on financial matters.



Rule Number Five for Issuer's Counsel: Be the Designated Cynic and Tire Kicker!

5

- A lot of times, the working group for the financing will have a “let’s cooperate and get the deal done” focus.
- That is fine, as long as things go well.
- Tell your client that you would like to play the role of the skeptic in the room to help protect the issuer and to encourage any problems to be surfaced.
- That does not mean you intend to kill the deal, but that you will be actively kicking the tires to protect the issuer.



The Issuer Counsel's Ultimate Role.

- This is not to say that the issuer's counsel is responsible for how others are conducting themselves in a financing.
- But, both of these SEC enforcement actions could have been avoided if the problems were noticed and addressed in a timely manner.
- Issuer's counsel may be in a position to help head off problems before they mushroom – so long as they are being alert and ask the right questions.
- Your ultimate role is: **PROTECT THE ISSUER!!!**





Questions?

Related Materials:

- [Solicitors: Help Avoid Targeting by the SEC in Municipal Bond Offerings | The Legal Intelligencer \(law.com\)](#)
- [Recent SEC Enforcement Actions Involving Municipal Bond Financings \(mcneeslaw.com\)](#)



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SEVEN LESSONS TO BE LEARNED FROM RECENT SEC ENFORCEMENT ACTIONS INVOLVING MUNICIPAL BOND FINANCINGS

July 5, 2022
Publications

By David Unkovic (<https://www.mcneeslaw.com/people/david-unkovic/>) and Ryan Gonder (<https://www.mcneeslaw.com/people/ryan-gonder/>)

Since September 2021, the United States Securities and Exchange Commission (the SEC) has brought five enforcement actions regarding municipal bond financings. The issuers of these bonds are Sweetwater Union High School District (Texas); Crosby Independent School District (California); Town of Sterlington (Louisiana); City of Rochester (and its school district) (New York); and Johnson City (Texas). In each case, the issuers and other involved parties were charged with providing false and misleading information to municipal bond investors. Enforcement was not limited to entities; individuals representing the issuers were also targeted. Additional information about these cases (and earlier cases) is available on the SEC website (<https://www.sec.gov/municipal/oms-enforcement-actions.html>).

Here are seven lessons to be learned from these cases:

- 1. Do not hide the truth and lie about the financial condition of the issuer, because the truth will eventually come out.** The bad acts one may be tempted to hide may include the theft of public money (Johnson City); the application of bond proceeds to unauthorized projects (Crosby – proceeds spent on unapproved football stadium improvements; Sterlington – proceeds spent on unapproved sports complex improvements); and providing false, overly-positive projections of future revenues and expenses (all five cases). Eventually, when a successor Chief Financial Officer (CFO) or the issuer's auditor reviews the books, the discrepancies and falsehoods will become painfully clear to all involved.
- 2. Do not mislead third parties who provide support for the marketing of the bonds.** In many of these cases, the issuers provided misleading information to rating agencies who were issuing ratings on the bonds. Those ratings were used to help market and price the bonds. When the truth came out, the rating agencies promptly lowered the ratings. In addition, in the Sterlington case, the issuer provided misleading information to the state Bond Commission which then gave its approval to the bonds. The issuer provided the state approval to investors as part of the

marketing of the bonds. The SEC is very focused on the misleading of third parties in bond issues.

3. **The issuer's CFO is often a target of the SEC in these situations.** The SEC usually does not want to assess fines against the issuer, because the innocent taxpayers of the issuer end up paying the bill. But the SEC has said that it "is committed to holding bad actors in municipal securities offerings accountable for their misconduct," and the SEC does impose fines on the municipal officials that are responsible for the bad behavior. In most of these cases, the CFO of the issuer was fined in the range of \$25,000 to \$30,000, and also prohibited from participating in future bond financings. In some cases, the targeted individual was the mayor or the chief administrative officer. Ultimately, the SEC will target whoever has taken the lead in providing the false and misleading information.
4. **Do not assist in covering up another official's bad behavior.** In one case (Crosby), the school superintendent directed the construction contractor to spend bond proceeds on football stadium improvements that were not approved by the school district's governing body. Instead of pushing back against the superintendent's improper direction, the CFO tried to smooth over the problem by various means, none of which solved the problem. As a result, the CFO was fined and prohibited from participating in any future bond financings. It essentially ended her career.
5. **Governing body: do not delegate all financial powers to one person.** In several of these cases, the CFO was delegated power to control all financial aspects of the issuer's operations, including budgeting; reporting financial matters to the governing body and to state oversight entities; entering into contracts related to the funded projects; and controlling all information given to rating agencies, bond professionals and, ultimately, the bond purchasers. If the person with all this control is the same person who has prepared the misleading financial information, any misdeeds are unlikely to be promptly caught. Issuers' governing bodies should institute internal checks-and-balances on the creation and dissemination of financial information by the issuer as an organization.
6. **Bond professionals and auditors must include a healthy degree of skepticism as part of their due diligence efforts.** In one case (Crosby), the SEC sanctioned the issuer's auditor, stating that the auditor failed to "exercise professional judgment" or "maintain professional skepticism." In another case (Sterlington), the issuer's financial advisor was a willing participant in developing the inappropriate misleading information. Bond professionals must realize that it is in the best interest of the issuer whom they serve to provide full and truthful information to investors in bond issues. This means not participating in the creation and dissemination of misleading information. And it means not accepting information provided by the issuer at face value; some healthy degree of professional skepticism is beneficial to the whole disclosure process. Ask relevant questions. Kick the tires.
7. **The harm caused by the misinformation can occur at many stages of a bond financing.** In many of these cases (Sweetwater, Crosby, and Rochester), the misinformation was included in the

offering disclosure document – usually an official statement in a public offering, but it could also be stand-alone financial projections provided to investors in a direct placement (Sterlington). If the misinformation relates to the current fiscal year (Sweetwater), the auditor will not yet have reviewed it. If the misinformation relates to a prior year (Crosby), then the auditor may have unwittingly included the misinformation in the audited financial statements that are part of the offering disclosure document. It is also possible that the misinformation arises after the issuance of the bonds (for example, misapplication of bond proceeds), and the investors are harmed when proper disclosure is not made in the issuer's periodic filings on Electronic Municipal Market Access (EMMA) (Johnson City) and secondary market trades are made based on incorrect information.

In all of these SEC cases, something fundamentally wrong was done by a person involved in the bond financing. When the bad act became publicly known, the SEC came in and took action against multiple parties involved in the transaction. It is therefore in the best interest of the issuer, and all others involved in the financing, to take seriously from the start of the transaction the need to provide full and accurate disclosure in the marketing of the bonds.

David Unkovic (dunkovic@mcneeslaw.com (mailto:dunkovic@mcneeslaw.com)) and Ryan T. Gonder (rgonder@mcneeslaw.com (mailto:rgonder@mcneeslaw.com)) are public finance attorneys with McNees Wallace & Nurick LLC in Harrisburg, Lancaster and Devon, Pennsylvania. David regularly provides ethics trainings for the National Association of Bond Lawyers and the Pennsylvania Association of Bond Lawyers. Ryan is also a school director at Central Dauphin School District.

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COMMENTARY

Solicitors: Help Avoid Targeting by the SEC in Municipal Bond Offerings

Even the general practice solicitor that handles all day-to-day legal issues for the client will play an important role in the financing process.

August 04, 2022 at 09:49 AM

By David Unkovic and Ryan T. Gonder | August 04, 2022 at 09:49 AM

All attorneys representing municipal and other public sector clients should be aware of the potential for a U.S. Securities and Exchange Commission (SEC) investigation of their clients' public bond deals. Issuers generally will hire a team of professionals with specialized experience in public finance to assist them in completing a financing; such professionals commonly include bond counsel, disclosure counsel, and a municipal advisor. But even the general practice solicitor that handles all day-to-day legal issues for the client will play an important role in the financing process.

Sometimes the best lessons are learned from studying the mistakes of others. In recent months, the SEC has publicized the results of multiple enforcement actions involving municipal bond financings. In each case, the issuers and other involved parties were charged with providing false and misleading information.

In this article we review two of those recent investigations, involving the Sweetwater Union High School District and Crosby Independent School District. While both actions involved "bad behavior" by the financial professionals involved in the deals, they present valuable lessons for all professionals involved in finance transactions, including attorneys serving as solicitor.

Sweetwater Union School District

The SEC's investigation of Sweetwater Union High School District (Sweetwater), near San Diego, California, involved allegations that Sweetwater and its CFO, Karen Michel, provided materially misleading statements about the district's financial status in connection with the sale of general obligation bonds issued by Sweetwater in 2018. Ultimately agreeing to a settlement of the charges in September 2021, Sweetwater was required to engage an outside financial professional (who was not involved in the bond issue) to clean up its financial operations; Michel agreed to a ban from participating in future municipal bond offerings and paid a \$28,000 penalty.

Sweetwater's troubles stemmed from its budget for the 2017-2018 fiscal year. Before the start of the fiscal year, Sweetwater implemented 3.75% raises for its employees. However, Michel failed to include the full cost of the salary increases in the budget. The effect of this omission was a projected ending general fund balance of \$19.5 million. If the 3.75% increase had been considered, the projected ending general fund balance would have been \$7.2 million in the red—a net swing of over \$26 million. Even though internal analyses by her office recognized the problem, Michel took many steps to cover up the actual deficit.

Michel was able to "hide the ball" here because she 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, Sweetwater's board authorized Michel to enter into all agreements and sign all documents related to the bonds.

The SEC determined that Michel misled her school board, the state of California, the rating agency, the underwriter and other professionals working on the bond issue, and the bond purchasers. Once the truth came out, Sweetwater's credit rating was downgraded from "A" to "BBB+" with a negative outlook.

Crosby Independent School District

The SEC's investigation of the Crosby Independent School District (Crosby), near Houston, Texas, also involved allegations of material misstatements by Crosby and its CFO, Carla Merka, about the district's financial status in connection with the sale of general obligation bonds issued by Crosby in 2018. Here, the SEC charged the district, Merka, and the district's auditor with providing the inaccurate information in connection with the sale of the bonds. The parties reached a settlement in 2022, resulting in a \$30,000 fine and participation ban for Merka as well as a three-year prohibition for the auditor from practicing before the SEC.

Like Sweetwater, Crosby's problems stemmed from issues with its financial statements. The district failed to report in its 2016-17 financial statements \$11.7 million in payroll and construction liabilities, and also falsely reported \$5.4 million in reserves. Merka was aware of these problems but did not inform the auditor who prepared the statements. She then provided the misleading financial statements for inclusion in the official statement for the bonds.

Perhaps not surprising, as this action involves a school district in Texas, the misstatements related to football. Crosby had previously issued bonds in 2013 to fund various capital projects, including improvements to its football stadium, but the cost of the stadium improvements exceeded the budget by a whopping \$12 million after the district's superintendent became actively involved in the stadium project and pushed for additional enhancements outside the original scope of work.

The district needed to bring another bond issue to market to cover the deficit, but to deal with the problem in the interim, it engaged in some creative accounting: the district changed its fiscal year end from Aug. 31 to June 30, resulting in a "savings" of \$3.8 million in teacher payroll expenses. These savings were nonexistent, however, as they were simply pushed into the next fiscal year; Merka did not inform the district's auditor that the amount was still outstanding and unpaid.

Like the CFO in Sweetwater, Merka was in total control of the financial processes for Crosby. She did not inform the professionals working on the 2018 bond deal of the issue.

It did not take long for this ruse to fall apart; Merka and the superintendent resigned shortly after the bonds were issued in January 2018, and by June, the district's new CFO had discovered the problem and disclosed it to the market later that summer. The result of the disclosure: the bonds that were sold in January were downgraded by the ratings agencies that had previously rated them and assigned negative outlooks.

So, with both of these investigations involving bad behavior on the part of the financial professionals, what does all this have to do with the solicitor? Even though the other professionals may be more experienced in public finance, none of them knows the issuer as well as the solicitor. The solicitor handles a wide variety of legal issues and has regular contact with the issuer's public officials and staff. Therefore, the solicitor should be attentive to what the issuer's board and staff are doing and assist the issuer in developing policies and procedures to avoid the types of issues seen in Sweetwater and Crosby.

Be Attentive. If, during the year, the issuer makes major decisions or takes extraordinary actions—including, for example, approving staff raises, selling property, buying property, undertaking new capital projects, incurring debt and expending debt proceeds—the solicitor should ask the CFO how these actions will affect the issuer's budget, in particular if they were not budgeted previously. The solicitor should ask the same questions of the issuer's auditor with respect to the issuer's financial statements.

When it comes to the bond issue, do not be afraid to ask questions if you do not understand what is going on. If you are confused, then your client is probably confused, too. Do not take "that's just the way it is done" as an answer; insist on clear explanations. Read through the proposed official statement and speak up if anything looks wrong or if something significant related to your client is not being disclosed.

Assist in Developing Policies and Procedures. In the SEC enforcement actions discussed above, the governing bodies of the issuers had delegated power to a single person (the CFO) over all financial aspects of the issuer's operations, including budgeting; reporting financial matters to the governing body and to state oversight entities; entering into contracts related to the funded projects; and controlling all information given to rating agencies, bond professionals and, ultimately, the bond purchasers. It is never a good idea to place all your eggs in one basket.

Issuers' governing bodies should take care to set up internal checks-and-balances on the creation and dissemination of financial information. If the issuer's staff is so small that one person must do everything, have the governing body designate one of its members (e.g., the Treasurer) to keep an eye on financial matters.

This is not to say that the solicitor is responsible for how others are conducting themselves in a financing. But, both of these SEC enforcement actions could have been avoided if the problems were noticed and addressed in a timely manner. Solicitors may be in a position to help head off problems before they mushroom—so long as they are being alert and ask the right questions.

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