

Client Alert

Current Issues Relevant to Our Clients

November 11, 2013

SEC Imposes Sanctions Against Municipal Issuer, Staff Member and Developer For Misleading Investors; Underwriter and Investment Banker For Due Diligence Failures

On November 5, 2013, the Securities and Exchange Commission charged the Greater Wenatchee Regional Events Center Public Facilities District, a municipal issuer in the State of Washington, a staff member of the District, a private developer and the president of the Developer with misleading investors in connection with a 2008 offering of Bond Anticipation Notes. In a separate enforcement action, the SEC further charged the Underwriter of the Notes and its lead investment banker for the Notes with failing to conduct sufficient due diligence in connection with the underwriting and offering of the Notes.

This enforcement action is notable in that the SEC imposed a \$20,000 fine on the District, marking the first time that the SEC has assessed a financial penalty against a municipal issuer.

Background

The District was formed in 2006 by the City of Wenatchee, Washington and eight neighboring municipalities and counties to assist with the financing of a multi-use arena and ice hockey rink (the “Facility”) to be located in the City. The City assumed primary responsibility for managing the development and construction of the Facility and City staff served as staff of the District. The District intended to finance the Facility through the issuance of long-term bonds and the City agreed to provide financial assistance to the District if the Facility’s revenue was insufficient to support payment on the proposed bonds. The District’s agreement with the construction lender required the District to make substantial lease payments to the lender if it was unable to purchase the Facility upon completion.

In connection with the structuring of the proposed bonds, the Developer prepared a series of financial projections for the operation of the Facility. The first two sets of projections were reviewed by an independent consultant who, in each instance, raised questions as to the economic viability of the Facility. Following the second review of the projections, City officials urged the Developer to revise the financial projections upward based on assurances by City officials that the community would support the Facility. In response, the Developer prepared more optimistic projections that were not provided to or reviewed by the independent consultant.

As a result of the economic crisis in 2008, it became impossible for the District to sell the proposed bonds and that effort was abandoned. In order to finance the purchase of the Facility and avoid making lease payments to the construction lender, the District hired the Underwriter for the Notes in late October 2008. An Official Statement was quickly prepared for the Notes based on the disclosure document relating to the proposed bonds, which included the Developer’s optimistic projections, and on November 13, 2008, the District sold the Notes in the amount of \$41,770,000. The principal of the Notes was due December 1, 2011 and was to be payable solely from the proceeds of a future series of long-term bonds. Following the completion of construction, the revenues of the Facility were substantially below the Developer’s projections and the District was unable to issue the bonds in 2011. As a result, the District defaulted on payment of the principal of the Notes at maturity.

Charges of Misleading Investors

The SEC’s charges against the District, the Developer and their related individuals were based upon the content of the Official Statement produced in connection with the offering of the Notes. The Official Statement contained language to the effect that the projected financial performance of the Facility had not been reviewed by any financial advisor or accounting firm in order to verify the reasonableness of the assumptions, the appropriateness of the preparation or the presentation of the projected

financial performance or the conclusions reached by such projections. The SEC found such statement to be materially false and misleading for failing to disclose the earlier reviews by the independent consultant questioning the Facility's financial potential and for failing to disclose the use of revised projections prepared by the Developer based on the more optimistic assumptions made by City officials.

Additionally, the SEC considered the Official Statement materially false and misleading for failing to disclose that the City's agreement to provide financial assistance was limited by the City's remaining debt capacity, which was insufficient to fully support the bonds expected to be issued to retire the Notes. The City's debt capacity limitation was described in the disclosure document prepared in connection with the originally proposed bond issue, but that information was deleted from the body of the Official Statement for the Notes. The SEC found the information regarding the limitation on the City's ability to support the take-out bonds to be material to purchasers of the Notes, as it suggested a potential difficulty in the sale of those bonds.

Charges of Insufficient Due Diligence

In bringing charges against the Underwriter and its lead investment banker, the SEC found that the Underwriter and investment banker did little to verify the information contained in the Official Statement and implicitly relied on the efforts of others. In its Order, the SEC reiterated that an underwriter in a negotiated municipal offering is obligated to develop a reasonable basis for belief in the accuracy and completeness of the statements in the Official Statement, which requires an inquiry into the key representations contained therein, and that mere reliance on the representations of an issuer is insufficient. In this case, the SEC found that the investment banker failed to conduct any due diligence regarding the Developer, did not review the independent consultant's reports on the revenues of the Facility and was unaware of the history of the changes in the Developer's revenue projections. The Underwriter's due diligence review was largely limited to a review of the disclosure document prepared for the originally proposed bond issue and the City's agreement to provide financial assistance. The Underwriter's due diligence policies and procedures were found to be deficient by the SEC as they provided little guidance to its investment bankers. As a result, the Underwriter was found by the SEC to have been negligent in recommending and selling the Notes to its customers for failing to have formed a reasonable basis for believing the truthfulness of the materially false and misleading Official Statement for the Notes.

Settlement

The SEC entered into settlement agreements with the District, the Underwriter, the Developer and certain individuals employed by the District, the Underwriter and the Developer under which all charged parties agreed to cease and desist from future violations of the Securities Act of 1933. The District agreed to pay a \$20,000 fine, representing the first time that the SEC has assessed a financial penalty against a municipal issuer. In the release announcing the disciplinary measures, the SEC noted that financial penalties against municipal issuers are appropriate for deterring misconduct when they can be paid without directly impacting taxpayers (such as from the operating revenues of an enterprise). The District further agreed to undertake certain remedial measures, including the establishment of disclosure policies consistent with Rule 15c2-12 of the Securities Exchange Act of 1934 and an ongoing training program for all District employees involved in municipal securities offerings or continuing disclosure.

The Underwriter agreed to pay a fine of \$300,000 and agreed, among other disciplinary measures, to subject itself to an independent review of its due diligence policies and procedures and to implement the recommendations suggested in such review. The Developer, its president and the Underwriter's lead investment banker were also subjected to various fines and disciplinary measures. In addition, in a separate settlement with the District, the Underwriter underwrote the long-term bonds issued to retire the Notes at a reduced fee and made a settlement payment to the District.

Take-Aways

This enforcement action makes clear that the SEC will honor its previous statements that it will hold accountable individuals involved in municipal bond transactions for deficient disclosures, including officers and employees of municipal issuers. It is also clear that the SEC will view the facts associated with the development of a difficult (or, as here, a defaulted) transaction in a manner that is not especially favorable for the transaction participants. Lastly, it is clear that issuers and underwriters alike will be well-served by adopting comprehensive disclosure and due diligence policies and procedures, and by providing regular training to their officers and employees regarding their obligations under the federal securities laws.

For More Information

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