

# Chapter 8

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## Disclosure Issues

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## § 8:1 Introduction

This chapter has been separated from chapter 14, which discusses fraud concepts, to allow readers who are dealing with practical issues in making official statement disclosure, continuing disclosure, or informal disclosure to set aside the elements of a section 10(b) action and focus on the realities of day-to-day drafting, or responding to investor requests for information. Deal lawyers probably have little concern with the reliance requirement or loss causation in an anti-fraud case. For this reason, law firm training sessions in public finance departments teach associates best practices in drafting documents for a financing in response to legal issues, but are unlikely to emphasize the elements of a fraud action. Chapter 14 is organized by reference to the issues that arise in litigation, although throughout chapter 14 there are practical comments and disclosure suggestions made in response to the opinions rendered in litigation and enforcement proceedings. For example, the section in chapter 14 on drafting tender offer disclosure documents fits better there than in this chapter because tender offer disclosure is readily discussed in the context of the rules governing tender offers. This chapter describes legal obligations, but is organized around everyday practical issues.

A review of the chapter 14 public finance cases is, however, important for lawyers making day-to-day disclosure decisions because the primary means by which the SEC regulates issuers of municipal securities is by enforcement actions under the antifraud rules. The SEC does not have the power to adopt rules detailing line item disclosures, and enforcement actions are important for providing lawyers with insights into the SEC's views on materiality and disclosure practices in the circumstances that are the subject of an enforcement proceeding.<sup>1</sup> Chapter 14 describes the unsuccessful effort of Robert Bradbury in an enforcement proceeding to claim that an official statement properly disclosed the risk that a future event "might"

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1. Sources for insights from litigation and enforcement actions include the website of the National Association of Bond Lawyers (NABL), in the section on securities law, and Paul Maco, who has a regular column in NABL's publication, *The Bond Lawyer*, which summarizes current enforcement activity and draws conclusions for lawyers making disclosure. See [www.nabl.org](http://www.nabl.org). Robert Doty, similarly, has a column in *The Municipal Finance Journal* and provides practical advice for the working group responsible for disclosure decisions based on the implications of enforcement proceedings and civil litigation. See, e.g., Doty, *Securities Law Application to Municipal Transactions Is Coming of Age*, 27 (4) MUN. FIN. J. 55 (Winter 2007). The SEC posts on its web page for the Office of Municipal Securities a collection of cases and materials on SEC enforcement proceedings involving municipal securities. NABL compiles important enforcement proceedings and no-action correspondence in its *Federal Securities Laws of Municipal Bonds* (3d ed. 2007).

occur when, in fact, he had actual knowledge the event “would” occur.<sup>2</sup> The chapter 14 discussion of the *Bradbury* case illustrates the scienter and materiality elements in a cause of action, and the lesson to be learned is there made clear. This chapter treats the issue by including a section on the purpose and organization of a risk factors section in an official statement, with suggestions on the writing of risk factors to prevent the result in *Bradbury*.

In addition to public finance enforcement actions, inferences on the disclosure views of the SEC can be made from the periodic and continuing disclosure requirements for 1934 Act reporting companies. Section 13 of the 1934 Act is the statutory basis for the 10-K (annual), 10-Q (quarterly), and 8-K (current) reports, and the implementing rules are the series of rules in Regulation 13A. Thus, Rule 13a-11 provides for material-event notices on Form 8-K, which parallel for corporate issuers the material-event notices required of municipal issuers under agreements made pursuant to Rule 15c2-12. Familiarity with the items detailed by the SEC for preparing Form 8-K may be useful in writing a material-event notice pursuant to Rule 15c2-12. The SEC’s changing views on the disclosure of predictions and other “soft information” illustrate the importance of being aware of SEC policies regarding corporate disclosure. Until the 1990s, soft information was likely to be regarded as misleading, but the SEC now requires disclosure of “known trends and uncertainties.”<sup>3</sup> The spillover effect of the SEC’s current view on corporate disclosure for public finance was apparent in an enforcement action in 2003 against the Massachusetts Turnpike Authority for failing to disclose expected project cost overruns related to Boston’s “Big Dig” tunnel project.<sup>4</sup>

Traditionally, Congressional policy, which was incorporated into the 1933 Act and the 1934 Act, focused on disclosure as the primary means of regulating issuers and the marketplace. The law of corporate governance was largely left to state legislatures. There was a marked change in 2002, in the aftermath of the Enron and WorldCom scandals, when Congress enacted the Sarbanes-Oxley Act.<sup>5</sup> Sarbanes-Oxley interjected the SEC into the corporate boardroom. For example, section 404 of Sarbanes-Oxley directs the SEC to prescribe rules requiring 1934 Act reporting companies to provide in their annual 10-K an internal control report stating the responsibility of management for an adequate internal control structure for financial

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2. *Dolphin & Bradbury Inc. v. SEC*, 512 F.3d 634 (D.C. Cir. 2008). See section 14:4.3.
  3. Regulation S-K, Item 303.
  4. *In re Mass. Turnpike Auth. and James J. Kerasiotes*, SEC Cease-and-Desist Order, Securities Act Release No. 8260 (July 31, 2003).
  5. Pub. L. No. 107-204, 116 Stat. 745 (2002).

reporting, and an assessment of the control structure for the previous year.<sup>6</sup> Sarbanes-Oxley does not apply to states and political subdivisions, but, as illustrated by the San Diego enforcement proceedings described below, Sarbanes-Oxley is a policy source for the SEC to apply in dictating remedial undertakings to establish internal controls. The implications of the Sarbanes-Oxley Act for issuers of municipal securities are discussed in section 1:7.7[B].

Although states and political subdivisions are not subject to Sarbanes-Oxley, and procedures for internal controls inspired by Sarbanes-Oxley policies may not be necessary for a majority of local governments, the SEC can turn a failure to have adequate internal controls into a securities law issue. The enforcement technique is to treat inadequate controls as a disclosure issue. Public finance lawyers are familiar with the SEC taking the position that an improper or “aggressive” analysis of tax exemption under the Internal Revenue Code should be disclosed to investors who would consider the danger of losing tax exemptions as material. In the same manner, the SEC can gain jurisdiction over an issue that appears to be a matter of state law. The SEC settled a cease-and-desist proceeding against the Utah Educational Savings Plan Trust (UESP or Trust) in 2005 for misleading statements and material omissions in disclosures to participants investing in Utah’s section 529 college savings plan.<sup>7</sup> The Trust deposited participant payments with outside fund managers to be pooled with payments from other participants in mutual funds and similar investments to achieve tax-deferred income for college savings. The accounting for individual participant accounts was a day off from the accounting for the pooled funds, with the result that gains in the pooled accounts were not allocated to individual participant accounts. The weakness in the Trust’s internal controls allowed an employee, Dale C. Hatch, to misappropriate over \$500,000 to accounts he controlled.

There are college savings programs in all fifty states, created by state law under statutes similar to statutes creating public authorities. Provisions for governance of college savings plans are generally a matter of extensive detail, and the following summary in the cease-and-desist order describes governance issues that would appear to be state law issues entirely outside the jurisdiction of the federal securities laws:

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6. See Regulation S-K, Items 307 and 308.
  7. *In re Utah Educ. Savings Plan Trust*, SEC Cease-and-Desist Order, Securities Act Release 8601 (Aug. 4, 2005). College savings plans established by state law to provide the benefits of section 529 of the Internal Revenue Code are described in section 2:9.2.

Hatch's misappropriation was made possible by weaknesses in UESP's system of internal controls, which he had implemented. Those weaknesses included: (1) providing certain UESP personnel unrestricted access to most functions on the UESP System; (2) inadequate separation of duties among personnel with access to the UESP System; (3) inadequate review of entries in the UESP System; and (4) flaws in the UESP System that allowed UESP personnel to alter prior transactions in the UESP System without an audit trail and to characterize transactions in the UESP system in a manner inconsistent with their actual nature.

Nevertheless, the SEC turned an issue of governing procedures into an issue of disclosure. Among the material misstatements and omissions found by the SEC were the following:

- A failure to disclose the manner by which participant transactions are effected and accounted for;
- A failure to disclose the known and ongoing internal control weaknesses discovered when Hatch's conduct was investigated; and
- A representation that the funds misappropriated by Hatch were "administrative funds" when in fact those funds should have been allocated to participant accounts.

Among the remedial undertakings agreed to by the Trust was an agreement to retain an independent consultant to assist it in establishing internal controls.

Sections 8:2.1 through 8:2.3 below use San Diego as a case study to describe one city's development of policies and procedures, an audit committee, and a disclosure practices working group. The organizational procedures undertaken by San Diego were in the aftermath of an enforcement action by the SEC and a series of internal investigations. As remediation undertakings, these procedures are probably not necessary for the majority of states and political subdivisions in creating financing policies, but the underlying ideas are worth considering by other issuers in reviewing their own internal controls.

In its 2012 Report on the Municipal Securities Market,<sup>7.1</sup> the SEC encouraged the preparation of policies and procedures by issuers of municipal securities, and made several references to endorsements of such actions by industry participants. In a section discussing disclosure controls and procedures, the SEC stated: "Organizations of attorneys have suggested that basic elements of any such controls and

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7.1. SEC, 2012 Report on the Municipal Securities Market (July 31, 2012), [www.sec.gov/news/studies/2012/munireport073112.pdf](http://www.sec.gov/news/studies/2012/munireport073112.pdf) [hereinafter 2012 Report on the Municipal Securities Market].

procedures should 'include (1) disclosure training for officials responsible for producing, reviewing, and approving disclosure, (2) establishing a procedure of accountability for review of relevant disclosure, and (3) ensuring that any procedures established are in fact followed.'"<sup>7.2</sup>

## § 8:2 Getting Organized

### § 8:2.1 Issuer Policies and Procedures

Corporate law provides background context for the SEC's 2006 enforcement action against the City of San Diego.<sup>8</sup> The administrative order found that San Diego committed securities fraud in the offer and sale of \$260 million of municipal securities in 2002 and 2003. In addition to a cease-and-desist order, the SEC, for the first time in a municipal settlement, required remedial undertakings that were consistent with themes in Sarbanes-Oxley. Among other things, the order obligated San Diego to retain an independent consultant acceptable to the SEC to conduct three annual reviews of San Diego's policies, procedures, and internal controls regarding (1) its disclosures for securities offerings, including disclosures made in its financial statements for annual continuing disclosure and presentations to rating agencies, (2) the hiring of internal personnel and external experts for disclosure functions, and (3) the implementation of active and ongoing training programs to educate specific personnel. The consultant was also to make recommendations regarding San Diego's policies, procedures, and internal controls; to assess compliance with the policies, procedures, and internal controls; to determine whether the consultant's recommendations were implemented; and to assess the effectiveness of the revised policies, procedures, and internal controls.

The SEC cannot mandate that states and political subdivisions establish written procedures for the control of financial information

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7.2. *Id.* at 109 (quoting American Bar Association Section of State and Local Government Law, American Bar Association Section of Business Law Committee of Federal Regulation of Securities & National Association of Bond Lawyers, DISCLOSURE ROLES OF COUNSEL IN STATE AND LOCAL GOVERNMENT SECURITIES OFFERINGS 65 (3d ed. 2009)).

8. *In re City of San Diego*, Cal., SEC Cease-and-Desist Order, Securities Act Release No. 8751 (Nov. 14, 2006). The SEC found that at the time of its offerings of municipal securities in 2002 and 2003, San Diego knew that it had materially large unfunded liabilities for pensions and retiree health care. The growing pension liability resulted, in part, from the city's deliberately underfunding its annual payment to the pension plan and from its increases in employee pension benefits over time. The SEC concluded that San Diego knew it would probably have difficulty in funding its future pension and healthcare obligations, and that the official statements were misleading in not disclosing these material facts.

and disclosure, but the clear signal from the San Diego enforcement proceeding is that the SEC believes states and political subdivisions would be well served to have written policies and procedures. There is considerable experience behind this viewpoint. The SEC and self-regulatory organizations require broker-dealer firms to have written policies and procedures for compliance, as though the firm policies and procedures were administrative rules applicable to the firm and sufficiently specific to provide a reference source for personnel. Routine examinations of firms by FINRA are likely to involve examination of policies and procedures. Broker-dealer firms will be the first to admit that (1) the drafting of policies and procedures, by itself, is likely to uncover practices that should be changed, (2) internal enforcement of policies and procedures is likely to avoid litigation and enforcement actions, (3) policies and procedures provide effective written material for employee training, and (4) the very existence of policies and procedures may satisfy FINRA at the commencement of a probe and prevent further inquiry. Rule 15c2-12(c) makes it unlawful for any broker or dealer to recommend the purchase or sale of a municipal security to a customer unless the firm has procedures in place to assure it will receive material-event notices required pursuant to Rule 15c2-12. Without procedures in place, the trading desk or sales personnel could easily overlook material-event notices. In short, policies and procedures are effective in preventing securities law problems.

The SEC has tried to use the San Diego experience to prod other states and political subdivisions to establish written policies and procedures. In a 2007 speech by Linda Thomsen, then the Director of Enforcement at the SEC,<sup>9</sup> the theme was lessons to be learned from the San Diego experience by others in the municipal market. The first of five lessons was this:

[C]ities should consider whether their internal controls and systems produce financial reports and disclosure documents that are accurate and complete. By internal controls and systems, I mean, among other things, written policies and procedures that, at a minimum:

- clearly identify who is responsible for what;
- clearly state the process by which the disclosure is drafted and reviewed; and

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9. Linda Thomsen, SEC Director of Enforcement, Speech at AICPA National Conference on Current SEC and PCAOB Developments, Washington, D.C.: Lessons Learned from San Diego (Dec. 11, 2007), available at [www.sec.gov](http://www.sec.gov).



- provide checks and balances so there is adequate supervision and reasonable disbursement of responsibilities so that too much power and information is not placed with just one person.

The SEC continued to cite the San Diego experience in its comprehensive 2012 Report on the Municipal Securities Market. There, the SEC stated: “The controls put in place as a result of the San Diego settlement have been cited by the attorneys in the municipal finance arena as a source of options that issuers should consider when determining what controls and procedures are appropriate for their circumstances.”<sup>9.1</sup> This statement was followed by a summary of San Diego’s restructuring of its controls and procedures.

There is no possibility of model policies and procedures, because of the extreme diversity in the governance of states and political subdivisions that issue municipal securities, and governance is a matter of state law. It bears emphasis that the legal rules separating government powers and locating governing responsibilities for state and local public bodies are a matter of state constitutional law and state legislation. Decisions on governmental procedures are to be made by public bodies within the specific legal framework in which they operate. However intended, the Thomsen recommendations should be read as ideas for consideration and not a backdoor means of imposing Sarbanes-Oxley on states and political subdivisions. In fact, many issuers of municipal securities (perhaps the majority) do not have sufficient complexity to justify written policies and procedures. If a local government retains a financial advisor to prepare its official statement, and the only officials that are necessary for providing the financial advisor with information are the finance officer and local attorney, policies and procedures will not be necessary. The three bullet points immediately above in the Thomsen speech are useful to help determine whether written policies and procedures would be useful. If, for example, “who is responsible for what” needs clarification, it may be that the government could benefit by written policies and procedures.

Policies and procedures for broker-dealer firms typically have statements and interpretations of the securities laws and requirements of the self-regulatory organizations followed by the firm’s procedures to assure compliance. Similarly, policies and procedures for government issuers could include statements of applicable federal and state law, the “recommended practices” written by the Government Finance Officers Association (GFOA) that the issuer is choosing to adopt as a matter of policy, the requirements of the Government Accounting Standards

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9.1. 2012 Report on the Municipal Securities Market, *supra* note 7.1, at 109.

Board (GASB), and state law accounting procedures that supplement or override GASB requirements and are relevant to disclosure. Following these statements, arranged topically, the procedures for compliance can be developed. A likely byproduct of drafting policies and procedures is that it exposes the necessity for training personnel. Thomsen made this point in her speech on lessons learned from San Diego:

[C]ities should provide training to their officials and employees regarding the applicable disclosure requirements of the federal securities laws and GASB financial reporting provisions. The SEC has repeatedly said that the ultimate responsibility for preparing disclosure documents cannot be assigned to the independent auditor, disclosure counsel, or other professionals. The ultimate responsibility rests with the issuer and its officials. Since the buck stops with municipalities and their officials it is essential to provide training. By training, I mean:

- practical training on the disclosure and financial reporting requirements of the federal securities laws and GASB;
- specific training on the particular person's role and responsibilities in the disclosure and financial reporting process; and
- training for everyone involved in the disclosure process—from the city counsel members to the staff members who are involved in the initial drafting of the disclosure documents.<sup>10</sup>

The remedial sanctions imposed on San Diego by the SEC were designed to supplement remedial actions being adopted by the city prior to the SEC's order. The SEC noted the hiring of individuals not affiliated with the city to act as the city's audit committee, which was charged with investigating the city's prior disclosure deficiencies and making recommendations to prevent future disclosure failures. The independent audit committee issued a report, known as the Kroll Report, that contained 121 recommendations for remedial action.<sup>11</sup> One important recommendation, derived from Sarbanes-Oxley, was to include in the city's year-end comprehensive annual financial report (CAFR) a management report, signed by the mayor and chief financial officer, describing the city's internal controls:

The Mayor and the CFO should annually include in the City's CAFR a signed management report on the financial statements and disclosures which shall include: (i) a statement of the City's responsibility for establishing and maintaining an effective system

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10. Thomsen, *supra* note 9.

11. Report of the Audit Committee of the City of San Diego (Aug. 8, 2006) [hereinafter Kroll Report].

of internal control over financial reporting and disclosures; (ii) a statement setting forth the City's assessment of the effectiveness of the internal controls as of the fiscal year-end, as well as identifying any material weaknesses in internal controls; (iii) a statement that, based on their knowledge, the CAFR does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the CAFR, in light of the statements made and circumstances under which they are made, not misleading with respect to the period covered, and (iv) a statement that the financial statement and other information included in the CAFR fairly present in all material respects the net assets and activities of the City for the period presented.<sup>12</sup>

The policy behind including a management report in the annual financial report is that transparency of internal controls is likely to lead to better controls than what the Kroll Report describes as San Diego's culture "premised upon non-transparency, obfuscation and denial of fiscal reality" among city officials.<sup>13</sup> The purpose of having the mayor and chief financial officer sign the management report and certify that it is not misleading and does not omit any material fact is to force upon these officials a due diligence obligation to assess the effectiveness of internal controls. These Sarbanes-Oxley procedures may or may not be appropriate in other municipal contexts, but, in some cases, it might be useful to consider disclosure of internal controls.

The Kroll Report further recommended that the city council be given fourteen days to review an official statement that it is being asked to authorize:

In the final analysis, if the City Council is to share responsibility for the accuracy of the City's disclosure documents, it is absolutely essential that the Council be given a reasonable opportunity to examine and ask questions about the disclosure documents it is authorizing to be disseminated to the public.

The Audit Committee therefore recommends that the City Council have at least two weeks to review substantially completed drafts of a preliminary offering statement before it is asked to vote to approve the final document.<sup>14</sup>

If policies and procedures are prepared, topics for consideration are the time period appropriate for the city council or other governing body to review, and the names of municipal officials to be contacted by members of the governing body during the review period to discuss

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12. *Id.* at 248.

13. *Id.* at 248-49.

14. *Id.* at 3.

any mistakes or red flags that are noticed. Since its Orange County investigation,<sup>15</sup> the SEC has emphasized the importance of giving legislative officials the opportunity to spot mistakes or red flags from their perspective as members of a separate branch of government. Martha Mahan Haines, chief of the office of municipal securities at the SEC, came back to this point in a 2006 speech at NABL's annual Bond Attorneys' Workshop:

I recognize that a review by governing officials won't replace the need for a full due diligence investigation by the financing team, but the officials should at least read relevant portions of the document before approving its use and point out misstatements and omissions that they notice to the financing team . . . .

. . . . Since municipal issuers have an affirmative obligation to know the contents of their disclosure documents, including their financial statements, they obviously need some period of time to read them. I realize that this will seem like a pain in the neck to some issuer executives and financing team members, but it's long past time to *get over it and get on with it*.<sup>16</sup>

Chairman Cox emphasized the importance of policies and procedures in a 2007 speech entitled "Integrity in the Municipal Market".<sup>17</sup>

When the responsible officials of a municipal issuer don't know what's in their disclosure documents, it's often a symptom of an even broader problem: the lack of disclosure controls, policies, and procedures for municipal issuers. And the fact is, even large issuers of municipal securities generally don't have policies and procedures to ensure accurate disclosure.

Chairman Cox then recommended that Congress enact limited regulatory legislation in respect of the municipal securities market, including these remarks on policies and procedures:

And it should be established that at least for large, complex, and frequent issuers of municipal securities, the issuer should have policies and procedures for disclosure that are appropriate to its circumstances.

A week after the Cox speech, the SEC delivered a white paper to Congress on the health of the municipal markets in which policies and procedures were again a focus of attention:

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15. See section 15:3.1.

16. See *THE BOND LAWYER* 24–25 (Dec. 1, 2006).

17. Christopher Cox, Chairman, SEC, Speech in Los Angeles: Integrity in the Municipal Market (July 18, 2007).

The staff is concerned that, regardless of size, issuers of municipal securities may lack policies or procedures adequate to ensure accurate and full disclosure in their offering documents and are not legally required to certify the accuracy of their disclosures. Furthermore, the Commission lacks the authority directly to require issuers to establish disclosure policies and procedures or to provide certifications. Unlike in the corporate context, in which there are requirements for disclosure controls, evidence obtained in many enforcement actions suggests that issuer officials who vote to approve the use of disclosure documents often assume the accuracy of disclosure documents and approve them with little or no review. Furthermore, the staff has observed that issuer representatives often have limited involvement in the preparation of disclosure documents.

The white paper concluded with a recommendation that Congress enact legislation “ensuring that issuers of municipal securities establish policies and procedures for disclosure appropriate for the particular issuer.” Congress could enact legislation requiring policies and procedures, or authorizing the SEC to promulgate rules on policies and procedures, without running up against the so-called Tower Amendment, because that 1975 limitation only prohibits the SEC from requiring states and political subdivisions to become part of the 1933 Act registration system, and the SEC has shown no interest in reviewing official statements prior to sale of municipal securities.

### **§ 8:2.2     Audit Committee**

The GFOA has recommended since 1997 that every government should establish an audit committee or its equivalent:

The auditor of a state or local government’s financial statements must be independent, both in fact and in appearance. A properly constituted audit committee helps to enhance the financial statement auditor’s real and perceived independence by providing a direct link between the auditor and governing board.

One important advantage of an audit committee is that it helps to facilitate communication between management, the auditors, and the governing board. An audit committee also limits the reliance governing bodies must place on the technical expertise of the independent auditor. An audit committee is useful, too, in helping to focus and document the government’s process for managing the financial statement audit.<sup>18</sup>

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18. GFOA, Recommended Practice, Establishment of Audit Committees (1997 and 2002), available at [www.gfoa.org](http://www.gfoa.org).

The SEC has adopted Rule 10A-3(b) pursuant to both section 10A of the 1934 Act and section 3 of Sarbanes-Oxley, to require that members of corporate audit committees be members of the board of directors, but otherwise independent. An independent board member is defined by the SEC as a board member who does not receive any compensation from the company other than for membership on the board or a committee. The Kroll Report recommended that San Diego establish a three-member audit committee that would be independent by reason of two members being appointed from the public and one member from the city council. The Kroll Report further recommended that “the city’s independent auditors should be retained by, report to, and take directions from, the Audit Committee.”<sup>19</sup> Section 10A(m) of the 1934 Act, which governs audit committees for companies trading on a national securities exchange, provides that the audit committee “shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer (including resolution of disagreements between management and the auditor regarding financial reporting) . . . and each such registered public accounting firm shall report directly to the audit committee.”

The SEC brought a civil action against the independent auditor, Calderon, Jaham & Osborn, the audit firm retained by both the City of San Diego and the city’s pension plan, and against the engagement partner for San Diego audits, Thomas Saiz.<sup>20</sup> The action charged Saiz with being a primary violator, and not a mere aider and abettor, because Saiz drafted the notes to financial statements that the SEC alleged were materially false and misleading regarding the city’s funding of its pension and retiree healthcare plans. The complaint further alleged that the footnotes did not conform to GASB Statement 27, “Accounting for Pensions by State and Local Governmental Employers,” and the complaint challenged the adequacy of the auditor’s investigation, implying the firm was incompetent and not qualified for the assignment. San Diego was then the seventh largest city in the United States, with revenues exceeding \$1 billion per year, but the Calderon firm had only thirty employees, and Saiz was the sole shareholder. Presumably, an independent audit committee would have hired an auditing firm qualified for the assignment. In the recommendations contained in her speech on lessons learned from San Diego, Linda Thomsen made the following observation:

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19. Kroll Report, *supra* note 11, at 251–52.

20. SEC v. Saiz, Litigation Release No. 20,394 (Dec. 11, 2007).

[H]ire auditors that have the skills and resources to do the job. Too often, cities seem to place too much emphasis on other factors—political connections, going with the lowest bid, or giving business to local business persons. The number one priority has to be hiring auditors who have the technical skills and resources to do the job.<sup>21</sup>

### **§ 8:2.3 Disclosure Practices Working Group**

The SEC order sanctioning San Diego acknowledged a remedial procedure implemented by the city itself in enacting an ordinance to create a disclosure practices working group. In the paragraph immediately before the paragraph imposing an independent consultant, the cease-and-desist order stated:

The City has also enacted ordinances designed to change the City's disclosure environment. First, the City created a Disclosure Practices Working Group, comprised of senior City officials from across city government. The Working Group is charged with reviewing the form and content of all the City's documents and materials prepared, issued, or distributed in connection with the City's disclosure obligations relating to securities issued by the City or its related entities; and conducting a full review of the City's disclosure practices and to recommend future controls and procedures. Second, the Mayor and City Attorney must now personally certify to the City Council the accuracy of the City's official statements. Third, the City Auditor must annually evaluate the City's internal financial controls and report the results to the City Council.

Creation of a disclosure practices working group was advocated in the Kroll Report, and the Kroll Report acknowledged the recommendation for this internal working group in the prior report to the city prepared by the law firm Vinson & Elkins:

In response to recommendations rendered by V&E, the City formally installed the DPWG [Disclosure Practices Working Group], comprised of the City Attorney, certain representatives of the City Attorney's office, the Auditor & Comptroller, the City Treasurer, the Deputy City Manager responsible for the financial management functions of the City, and the City's outside disclosure counsel. The DPWG is responsible for the design and implementation of a program that ensures the City's

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21. Thomsen, *supra* note 9.

compliance with disclosure controls and procedures (through an annual evaluation), oversight of mandatory disclosure training of City staff, and review of all City offering documents prepared as part of the City's public disclosure. As an element of this Remediation Plan we endorse the continuation of the DPWG, though we recommend a change in its composition. Given the enormous responsibility of the CFO to ensure the accuracy of the City's financial statements, the CFO should be a member of the DPWG and serve as its chair. As reconstituted, with the DPWG reporting to the City's new Audit Committee, as we also recommend, the DPWG can render meaningful assistance to the City (and particularly to the Mayor and CFO) in discharging their obligations to consider the materiality of information and to determine the City's disclosure responsibilities, consistent with best practices observed in the private sector.<sup>22</sup>

If a city or other government drafts policies and procedures, the drafting exercise will probably make clear which officials should be responsible for the various disclosure obligations. The identification of named officials for specific responsibilities leads to accountability and prevents obfuscation of disclosure roles. The assignment of responsibilities can be categorized by reference to the different circumstances involving disclosure: preparation and review of an official statement at the time of a new issue of securities, responsibility for annual and material-event disclosure pursuant to obligations under continuing disclosure agreements, and control over informal disclosure, including market notices, press releases, responses to inquiries from investors, and website management. In the case of a new issue of securities, a working group can be identified to prepare an official statement and work with outside advisors, underwriters, and lawyers. Other officials may have specific responsibilities for the review of all or portions of a draft official statement, and various departmental employees may be assigned to give input to the drafting working group on topics in the official statement. A timeline for review by officials and the governing body that is to authorize delivery of the official statement will give notice to the underwriters that the issuer is in control of the timing of the marketing of its securities.

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22. Kroll Report, *supra* note 11, Appendix M, at M-4 to M-5 (referring to Paul S. Maco & Richard C. Sauer, Vinson & Elkins LLP, Report on Investigation, The City of San Diego, California's Disclosures of Obligations to Fund the San Diego Employees Retirement System and Related Disclosure Practices 1996–2004 with Recommended Procedures and Changes to the Municipal Code (Sept. 16, 2004)).



**§ 8:2.4 Issuer Websites****[A] Considerations in Deciding Whether to Have a Website**

On August 1, 2008, the SEC published an interpretive release, effective August 7, 2008, addressing a number of issues related to the corporate use of websites in making informal disclosure (2008 Web Site Guidance).<sup>23</sup> The 2008 Web Site Guidance is directed at companies subject to the reporting requirements of the 1934 Act and Regulation FD on selective disclosure, but the 2008 Web Site Guidance should also be referenced by issuers of municipal securities who have, or are considering, a website as a means of making disclosure to the public. Informal disclosure in public finance refers to disclosure other than official statements, annual continuing disclosure, and material-event disclosure mandated by Rule 15c2-12, or the CAFR. Informal disclosure essentially consists of updating information about the issuer, meeting with analysts, taking steps to assure that all investors have relatively equivalent information, and making press releases intended for investors.

The clear implication of the 2008 Web Site Guidance is that the SEC is encouraging the active development of corporate websites. Filing documents for posting on the SEC's EDGAR is not affected, but the SEC notes that certain rules, such as proxy disclosure rules, have been modified to encourage website postings. One commentator has suggested that electronic disclosure is developing so rapidly that in the future the only information that may be required to be filed with the SEC will be a reporting company's Internet address.<sup>24</sup> The municipal marketplace lacks the efficiency of the flow of information that exists for highly traded corporate securities, and the diversity of municipal issuers, including conduit issuers, makes it very unlikely that municipal websites will replace required filings with the MSRB for posting on its Electronic Municipal Market Access System (EMMA) anytime in the foreseeable future. Although municipal websites are not as likely to be part of the regulatory fabric as corporate websites, the SEC's encouragement of electronic communications is worth noting by municipal issuers. The general attitude of the SEC is made apparent at the beginning of the 2008 Web Site Guidance:

We have long recognized the vital role of the Internet and electronic communications in modernizing the disclosure system

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23. Commission Guidance on the Use of Company Web Sites, Exchange Act Release No. 58,288 (July 28, 2008).

24. BROWN, CORPORATE DISCLOSURE 9-8 (2009-2 Supplement).

under the federal securities laws and in promoting transparency, liquidity and efficiency in our trading markets. Central to the effective operation of our trading markets is the ongoing dissemination of information by companies about themselves and their securities . . . .

Indeed, because we recognize the enormous potential for the Internet to promote the goals of the federal securities laws, we wish to continue to encourage companies to develop their web sites in compliance with the federal securities laws so that they can serve as effective information and analytical tools for investors. Enhanced company web site presentation of information can benefit investors of all types by enabling them to gather information about a company at a level of detail they believe is satisfactory for their purposes.

Among the existing rules of the SEC related to websites is a requirement that the 1934 Act annual report on Form 10-K provide the address of the company website, if the company has one, and that the company state whether the 1934 Act reports are available on its website. To follow this pattern, a municipal issuer that has an active website for purposes of disclosure to investors should consider the appropriateness of providing its website address in the official statement and annual continuing disclosure, and should also consider whether to include a statement describing the disclosure documents posted on the website. The address should not be provided unless the issuer is prepared to have investors access the website for disclosure information. There are numerous sources of information advising municipal issuers on the maintenance of websites, including recommended practice statements by the GFOA. The 2008 Web Site Guidance, in the course of covering regulatory subjects, makes several observations on website management that can be adapted for municipal issuers. For example, the site for investor disclosure should be separated from other municipal issuer website information, such as tourist promotion and political speeches. A distinct investor relations site should be prominently displayed on the issuer's home page, and the issuer should recognize that all material on the investor relations site is considered by the SEC as speaking to investors and thus subject to the antifraud rules, along with any other information on the issuer's website that gives the impression it is addressed to investors. The SEC in 2008 repeated what it said in its 2002 release on the use of electronic media.<sup>25</sup>

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25. Use of Electronic Media, Securities Act Release No. 7856, Exchange Act Release No. 42,728 (Apr. 28, 2002).

Issuers are responsible for the accuracy of their statements that reasonably can be expected to reach investors or the securities market regardless of the medium through which the statements are made, including the Internet.<sup>26</sup>

The 2002 release added:

It is important for issuers, including municipal securities issuers, to keep in mind that the federal securities laws apply in the same manner to the content of their web sites as to any other statements made by or attributable to them.<sup>27</sup>

The 2008 Web Site Guidance stresses the accessibility of the website if it is to be used for “public” dissemination of information. Nevertheless, any reference to the website address for investor relations information made in an electronic version of the official statement should ordinarily not be in the form of a hyperlink. A hyperlink draws the hyperlinked material into the official statement. The point was made in the 2002 release with respect to hyperlinks to third-party sites:

Under Rule 15c2-12, a final official statement can be a single document or set of documents. In a municipal securities offering, if a municipal securities issuer puts its official statement on its web site and also establishes hyperlinks to other web sites, a question arises as to what constitutes the final official statement that a municipal securities underwriter has an obligation to obtain and send to potential customers. For purposes of satisfying its obligations under Rule 15c2-12, a municipal securities underwriter may rely on the municipal securities issuer to identify which of the documents on, or hyperlinked from, the issuer’s web site comprise the preliminary, deemed final and final official statements, even if the issuer’s web site contains other documents or hyperlinks to other web sites. Hyperlinks embedded within an official statement itself, however, will be considered part of the official statement, even if a municipal securities issuer has not specifically identified the embedded hyperlinked information. For any municipal securities offering subject to Rule 15c2-12, the paper and electronic versions of each of the preliminary, deemed final and final official statements must be the same.<sup>28</sup>

There may be cases in which an issuer prepares an electronic official statement and does intend to include in the official statement specific information on its website or from a third-party site. For

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26. *Id.* section II.B.I.

27. *Id.* section II.B.

28. *Id.* section II.A.4.

example, a number of state authorities may be entitled to payments from the state. The lawyers conclude that information about the state is material to the investors of each of the authorities, and the state thus provides segregated information on its website that is to be incorporated into the official statements of the authorities by a hyperlink. Liability issues in connection with the hyperlinked information are discussed below in the section on hyperlinks.

### **[B] Official Statement Archives**

Based on comments from the public, the MSRB determined in 2007 to construct its EMMA site to allow official statements to remain available on the EMMA site until the final maturity date.<sup>29</sup> The MSRB acknowledged the importance of much of the official statement information, including redemption provisions, document summaries and covenants, and the bond counsel opinion, throughout the life of the bonds. Issuers may similarly conclude that official statements should remain on the issuer website until final maturity. Old disclosure documents should be in an archive separate from current information, with an entry notice that the documents are dated as of their date, and that the issuer has not undertaken any updates of the archived official statements. An alternative is to reference the location of the official statements on EMMA and possibly provide a hyperlink from the website to EMMA.

The 2008 Web Site Guidance acknowledges earlier concerns of website sponsors that posting dated material could constitute a republication as of the posting date for purposes of applying the antifraud rules. The SEC updates current guidance regarding the effect of accessing previously posted materials or statements on company websites so that such previously posted materials or statements would not, without more, be considered reissued or republished for purposes of the antifraud provisions of the federal securities laws, including any duty to update such information:

We do not believe that companies maintaining previously posted materials or statements on their web sites are reissuing or republishing such materials or information for purposes of the antifraud provisions of the federal securities laws just because the materials or statements remain accessible to the public. Of course, the antifraud provisions would apply to statements contained in posted materials when such statements were initially made. If a company affirmatively restates or reissues a statement, the antifraud provisions would apply to such statements when the company restates or reissues the statement. This affirmative

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29. See Exchange Act Release No. 57,577 (Mar. 28, 2008).

restatement or reissuance may create a duty to update the statement so that it is accurate as of the date it is restated or reissued. As a general matter, we believe that the fact that investors can access previously posted materials or statements on the company's web site does not in itself mean that such previously posted materials or statements have been reissued or republished for purposes of the antifraud provisions of the federal securities laws, that the company has made a new statement, or that the company has created a duty to update the materials or statements.

Website sponsors have developed relatively common practices for identifying dated material. For example, the SEC website pages for dated public speeches by SEC commissioners and staff are accessed by the user clicking on a specific year. It is clear from the year indication that the speech is dated, and that the SEC is not updating the views expressed in the speech. The MSRB uses the same method for archived notices. The 2008 Web Site Guidance comments:

In circumstances where it is not apparent to the reasonable person that the posted materials or statements speak as of a certain date or earlier period, then to assure that investors understand that the posted materials or statements speak as of a date or period earlier than when the investor may be accessing the posted materials or statements, we believe that previously posted materials or statements that have been put on a company's web site should be:

- Separately identified as historical or previously posted materials or statements, including, for example, by dating the posted materials or statements; and
- Located in a separate section of the company's web site containing previously posted materials or statements.

### **[C] Is Website Disclosure “Public” Disclosure?**

The topic that receives the most attention in the 2008 Web Site Guidance is a discussion of factors to be applied in determining whether there is public dissemination of information to avoid selective disclosure problems under Regulation FD.<sup>30</sup> Regulation FD was adopted to address the problem of disclosure of material nonpublic information by public companies to a select group of parties who could then gain an unfair advantage over the rest of the market. Regulation FD applies primarily to 1934 Act reporting companies and requires that (1) when

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30. Selective Disclosure and Insider Trading, Securities Act Release No. 7881 [Aug. 15, 2000].

an issuer intentionally discloses material information, the issuer must do so through public disclosure, and not through selective disclosure, and (2) whenever an issuer learns that it has made a nonintentional material selective disclosure, the issuer must make prompt public disclosure of the information. The interpretive problem has been what constitutes “public” disclosure and whether a company’s website is an appropriate channel for public communications. Issuers of municipal securities frequently have been making informal disclosures to the marketplace, even where there is not a material event required to be disclosed under Rule 15c2-12, and when there is no general securities law duty to make a public disclosure. Municipal issuers have asked their lawyers for guidance on the appropriate channel of communication, particularly during the period when there has been a phasing-out of the multiple nationally recognized municipal information repositories as recipients of Rule 15c2-12 continuing disclosure, and while EMMA was in transition from a pilot project to a permanent repository. Continuing disclosure required by Rule 15c2-12 was required to be filed solely with the MSRB for posting on EMMA beginning July 1, 2009.

Municipal issuers have considered making “public” disclosures on their websites of information intended for investors, but not mandated by Rule 15c2-12. Issuers of municipal securities are generally not 1934 Act reporting companies, and not subject to the strictures of Regulation FD, but the 2008 Web Site Guidance provides useful information for considering “public” dissemination on a website, and website management to improve public awareness of the site. The approach taken by the SEC is to consider, first, whether the website is a recognized channel of communication and, second, whether information on the website is disseminated to the securities marketplace in general. Whether the website is a recognized channel of communication depends on the steps the issuer has taken to alert the market to the website and the issuer’s disclosure practices, and whether the site is actually used by investors and market participants to find disclosure information. With respect to the second factor, dissemination, the SEC recognizes the broad acceptance of electronic communications and suggests that the analysis of dissemination should focus on (1) the manner in which information is posted on a website and (2) the timely and ready accessibility of such information to investors and the markets. The 2008 Web Site Guidance lists the following “non-exclusive” factors to consider in evaluating whether a website is a recognized channel of distribution and whether information on the site is “posted and accessible” and, therefore, disseminated:

- Whether and how companies let investors and the markets know that the company has a web site and that they should look at the company’s web site for information. For

example, does the company include disclosure in its periodic reports (and in its press releases) of its web site address and that it routinely posts important information on its web site?

- Whether the company has made investors and the markets aware that it will post important information on its web site and whether it has a pattern or practice of posting such information on its web site;
- Whether the company's web site is designed to lead investors and the market efficiently to information about the company, including information specifically addressed to investors, whether the information is prominently disclosed on the web site in the location known and routinely used for such disclosures, and whether the information is presented in a format readily accessible to the general public;
- The extent to which information posted on the web site is regularly picked up by the market and readily available to the media, and reported in, such media, or the extent to which the company has advised newswires or the media about such information and the size and market following of the company involved. For example, in evaluating accessibility to the posted information, companies that are well-followed by the market and the media may know that the market and the media will pick up and further distribute the disclosures they make on their web sites. On the other hand, companies with less of a market following, which may include many companies with smaller market capitalizations, may need to take more affirmative steps so that investors and others know that information is or has been posted on the company's web site and that they should look at the company web site for current information about the company;
- The steps the company has taken to make its web site and the information accessible, including the use of "push" technology, such as RSS feeds, or releases through other distribution channels either to widely distribute such information or advise the market of its availability. We do not believe, however, that it is necessary that push technology be used in order for the information to be disseminated, although that may be one factor to consider in evaluating the accessibility to the information;
- Whether the company keeps its web site current and accurate;
- Whether the company uses other methods in addition to its web site posting to disseminate the information and whether and to what extent those other methods are predominant methods the company uses to disseminate information; and
- The nature of the information.

One means of coordinating the municipal issuer's website with EMMA is to post a notice on EMMA that certain material information is being posted on the issuer's website. The SEC makes this suggestion in connection with corporate websites and EDGAR:

If the information is important, companies should consider taking additional steps to alert investors and the market to the fact that important information will be posted—for example, prior to such posting, filing or furnishing such information to us [EMMA in the case of municipal disclosure] or issuing a press release with the information.

It bears repeating that website disclosure does not replace regulatory mandates for methods of disclosure. Thus, private companies cannot use website disclosure as a substitute for disclosure of material events required to be filed with the SEC on Form 8-K or press releases required by stock exchange rules. Likewise, municipal material-event notices that were required by Rule 15c2-12 to be filed with the MSRB for posting on EMMA after July 1, 2009, and filings required by MSRB rules, are not affected despite duplicate postings on the issuer's website. If, however, a municipal issuer is notifying the market that it is maintaining an active investor relations website for disclosure, any material-event notices required to be filed with the MSRB (and located on EMMA) should also be posted on the issuer's website.

#### **[D] Hyperlinks from Websites to Third-Party Sites**

As stated earlier, hyperlinks from an official statement to the issuer's website or to a third-party site should be avoided unless the hyperlink is limited to segregated information intended to be part of the official statement for review and delivery by the underwriter. The issues for hyperlinks from the website to third-party websites are somewhat different. The 2008 Web Site Guidance discusses how companies can hyperlink to third-party websites without "adopting" the third-party information for liability purposes. The SEC suggests, among other things, that companies explain the context for the hyperlink to make clear why the hyperlink is being provided. Companies should be aware that selective choices to hyperlink specific third-party information may indicate that the company has a positive view or opinion about that information, and should consider using other methods to denote that the hyperlink is to third-party information:

Under section 10(b) of the Exchange Act and Rule 10b-5, a company can be held liable for third-party information to



which it hyperlinks from its web site and which could be attributable to the company. As we explained in the 2000 Electronics Release, whether third-party information is attributable to a company depends upon whether the company has: (1) involved itself in the preparation of the information, or (2) explicitly or implicitly endorsed or approved the information. In the case of company liability for statements by third parties such as analysts, the courts and we have referred to the first line of inquiry as the “entanglement” theory and the second as the “adoption” theory. . . .

We understand that some companies may still wish for further elaboration of some of the issues addressed regarding the application of the adoption theory. . . .

In evaluating the potential antifraud liability of a company under the adoption theory with respect to third-party information to which the company provides a hyperlink in the context of providing information about the company and its business, we believe the focus should be on whether a company has explicitly or implicitly approved or endorsed the statement of a third-party such that the company should be liable for that statement. Because an explicit approval or endorsement is, by definition, plainly evident, the analytical scrutiny is on the circumstances or conditions under which a company can fairly be said to have implicitly approved or endorsed a third-party statement by hyperlinking to that information. The key question in the hyperlinking context, therefore, is: Does the context of the hyperlink and the hyperlinked information together create a reasonable inference that the company has approved or endorsed the hyperlinked information?

We believe that in evaluating whether a company has implicitly approved or endorsed information on a third-party web site to which it has established a hyperlink, one important factor is what the company says about the hyperlink, including what is implied by the context in which the company places the hyperlink. In considering the context of the hyperlink, we begin with the assumption that providing a hyperlink to a third-party web site may be of interest to the users of its web site. Otherwise, it is unclear to us why the company would provide the link. To avoid potential confusion or misunderstanding about what the company’s view or opinion is with respect to the information to which the company has provided a hyperlink, the company should consider explaining the context for the hyperlink—and thereby make explicit, rather than implicit, why the hyperlink is being provided. For example, a company might explicitly endorse the hyperlinked information or suggest that the hyperlinked information supports a particular assertion on the company’s web site.

Alternatively, a company might simply note that the third-party web site contains information that may be of interest or of use to the reader.

In addition to recommending explanations for the hyperlinks, the 2008 Web Site Guidance recommends techniques that prompt the user that the material is separate:

In addition to an explanation of why a company is including particular hyperlinks on its web site, a company also may determine to use other methods, including “exit notices” or “intermediate screens,” to denote that the hyperlink is to third-party information. While the use of “exit notices” or “intermediate screens” helps to avoid confusion as to the source of the third-party information, no one type of “exit notice” or “intermediate screen” will absolve companies from antifraud liability for third-party hyperlinked information.

Finally, the SEC repeats its standard negative view of the use of disclaimers to insulate a person from liability: “[A] company would not be shielded from antifraud liability for hyperlinking to information it knows, or is reckless in not knowing, is materially false or misleading.” However, a disclaimer can be drafted to provide disclosure as much as to create a shield. For example, one way to draft an “exit notice” is by use of disclaimer language, because the disclaimer clearly discloses the fact that there is an exiting.

### **[E] Summary Statements on Websites**

The 2008 Web Site Guidance provides antifraud guidance for companies that include summaries of information on their websites, including techniques that companies can use to highlight the summary nature of the information provided. The SEC, for some time, has favored the use of summaries for disclosure as a means of simplifying information so that it will be read by investors.<sup>31</sup> Like the drafting of a “management discussion and analysis,” the preparation of a summary places a burden on the issuer to be certain there are no material omissions, and that the summary is not misleading.

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31. The SEC in the 2008 Web Site Guidance states:

We have encouraged and, in some cases, required the inclusion of summaries or overviews in prospectuses and in Exchange Act reports to highlight important information for investors. We believe that summary information can be particularly appropriate and helpful to investors, such as when it relates to lengthy or complex information.

We encourage companies that use summaries or overviews of more complete information located elsewhere on their web sites to consider employing disclosure and other techniques designed to highlight the nature of summaries or overviews in order to help minimize the chance that investors would be confused as to the level of incompleteness inherent in these disclosures. To this end, companies may wish to consider the following techniques that may highlight the nature of summary or overview information:

- *Use of appropriate titles.* An appropriate title or heading that conveys the summary, overview or abbreviated nature of the information could help to avoid unnecessary confusion;
- *Use of additional explanatory language.* Companies may consider using additional explanatory language to identify the text as a summary or overview and the location of the more detailed information;
- *Use and placement of hyperlinks.* Placing a summary or overview section in close proximity to hyperlinks to the more detailed information from which the summary or overview is derived or upon which the overview is based could help an investor understand the appropriate scope of the summary information or overview while making clearer the context in which the summary or overview should be viewed; and
- *Use of “layered” or “tiered” format.* In addition to providing hyperlinks to more complete information, companies can organize their web site presentations such that they present the most important summary or overview information about a company on the opening page, with embedded links that enable the reader to drill down to more detail by clicking on the links. In this way, viewers can follow a logical path into, and thereby obtain increasingly greater details about, the financial statements, a company’s strategy and products, its management and corporate governance, and the many other areas in which investors and others may have an interest.

### **[F] Interactive Websites: Chat Rooms and Blogs**

The 2008 Web Site Guidance addresses antifraud issues that may arise when issuers, their officers, and employees speak on company-sponsored blogs or electronic shareholder forums. In particular, the SEC provides guidance for companies hosting or participating in blogs or electronic shareholder forums about the applicability of the anti-fraud provisions to statements made by the company or by a person acting on behalf of the company. The SEC also highlights the restrictions on a company’s ability to require investors to waive protections

under the federal securities laws as a condition to entering or participating in a blog or forum.

The SEC encourages interactive websites as a means of communicating information: “We believe that it is important to provide guidance that will promote robust use by companies of their web sites. One example of such robust use is making the company web site interactive.” Any communication by the company to investors, even in the informal setting of a chat room or blog, is, however, subject to the antifraud rules comparably to a press release.

We acknowledge the utility these interactive web site features afford companies and shareholders alike, and want to promote their growth as important means for companies to maintain a dialogue with their various constituencies . . . . Accordingly, we are providing the following guidance for companies hosting or participating in blogs or electronic shareholder forums:

- *The antifraud provisions of the federal securities laws apply to blogs and to electronic shareholder forums.* As stated above, companies are responsible for statements made by the companies, or on their behalf, on their web sites or on third-party web sites, and the antifraud provisions of the federal securities laws reach those statements. While blogs or forums can be informal and conversational in nature, statements made there by the company (or by a person acting on behalf of the company) will not be treated differently from other company statements when it comes to the antifraud provisions of the federal securities laws. Employees acting as representatives of the company should be aware of their responsibilities in these forums, which they cannot avoid by purporting to speak in their “individual” capacities.
- *Companies cannot require investors to waive protections under the federal securities laws as a condition to entering or participating in a blog or forum.* Any term or condition of a blog or shareholder forum requiring users to agree not to make investment decisions based on the blog’s or forum’s content or disclaiming liability for damages of any kind arising from the use or inability to use the blog or forum is inconsistent with the federal securities laws and, we believe, violates the anti-waiver provisions of the federal securities laws. A company is not responsible for the statements that third parties post on a web site the company sponsors, nor is a company obligated to respond to or correct misstatements made by third parties. The company remains responsible for its own statements made (including statements made on its behalf) in a blog or a forum.

The use of interactive websites probably has more dangers than benefits.<sup>32</sup> Chat rooms and blogs tend to employ informal language and slang when the reality is that when a person is in a position to speak on behalf of the issuer, the antifraud rules will apply. The same standard of care applies in chat rooms and blogs as would apply to a press release or news conference that typically involves tight controls. The issuer may simply say “yeah” to a comment made by another person, and suddenly the antifraud “adoption” theory applies. Issuer representatives can also appear in another person’s chat room or blog, and, if the information is reaching the issuer’s own investors, the antifraud rules would apply. A simple analogy for considering the implications of blog participation is the appearance of a corporate or municipal official on CNBC or some other television station for a business interview. Personnel who make those appearances are usually trained to represent the issuer competently without making misleading statements or revealing nonpublic material information. Regardless of the decision on chat room or blog participation, issuers should consider having policies and procedures to educate and control personnel as to the use and implications of chat rooms and blogs.

### **[G] Website Management**

Personnel responsible for management of the website should include people fully aware of the legal issues implicit in the use of websites for purposes of disclosure, such as the public finance selective disclosure issues that are, at least partially, analyzed by reference to Regulation FD. There should be overlap or coordination between personnel involved in formal disclosure, including those responsible for material-event disclosure to be filed with the MSRB and posted on EMMA, and those administering the website. As stated earlier, material-event notices on EMMA should also be on the website, and website postings that are considered material should probably also be filed (or referenced) with the MSRB, despite there not being a Rule 15c2-12 requirement. It should be assumed that EMMA will be a primary source of issuer information for most investors.

Public finance poses a unique problem for website design. The issuer that maintains the website may have a number of outstanding securities that have different sources of payment, indentures, and security provisions. The investor in the issuer’s water revenue bonds should have access to information appropriate to water revenues as well as to the

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32. But note that the GFOA, in a 2009 Recommended Practice release, stated: “A web site can offer two-way, multi-conversational, or interactive formats. This capacity may be especially helpful for proposed documents or citizen surveys.” GFOA, Recommended Practice, Web Site Presentation for Official Financial Statements (2009), *available at* [www.gfoa.org](http://www.gfoa.org).

general fund information being reviewed by investors in general obligation bonds, but if general funds are not a source of repayment for the water revenue bonds, the website should be designed to separate sources of repayment and security for different types of obligations. The same principles that apply to drafting official statements and to enterprise fund accounting should be considered in the design of websites. “Exit notices” or “intermediate screens” may be necessary to avoid confusion, as though each type of bond financing were considered a separate issuer with a separate website.

## § 8:3 Drafting the Official Statement

### § 8:3.1 Plain-English Considerations

In 1997, the SEC published a plain-English rule proposal,<sup>33</sup> which it adopted in 1998.<sup>34</sup> The plain-English rules apply to prospectuses for securities registered under the 1933 Act, but people drafting official statements may find it useful to consider the principles. Drafters of official statements are likely to resist the move toward plain English, because issues of municipal debt that are secured by tightly drafted legal documents must be described by tightly drafted disclosure using legal terms. This position is certainly tenable, but consider also the opening words of the SEC’s 1997 proposal:

One of the fundamental protections provided to investors by our federal securities laws is full and fair disclosure, but investors must be able to understand these disclosures to benefit from them. Prospectuses often use a complex, legalistic language that is foreign to all but financial or legal experts . . . .

When initially considering the change from a formal, legalistic writing style to plain English, the following reservations often are raised: (1) legal language is more accurate . . . .

In using plain English, you are not forced to choose between clarity and precision. The disclosure obviously must be correct, but plain English often is more precise than the obscure and complex writing style that is prevalent in prospectuses. . . . Needless wordy documents can actually increase ambiguity and usually hide important facts. Ambiguities and omissions that go unnoticed in long and turgid documents become more obvious when these documents are written in plain English, and are more likely to be detected and corrected by those who review these documents for accuracy.<sup>35</sup>

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33. Securities Act Release No. 7380 (Jan. 14, 1997).

34. Securities Act Release No. 7497 (Jan. 28, 1998).

35. Securities Act Release No. 7380, at 1, 17 (Jan. 14, 1997).

Rule 421(b) requires clear writing for the entire prospectus, but the plain-English requirement of Rule 421(d) applies only to the cover pages, the summary, and the risk factors section:

- (d) (1) To enhance the readability of the prospectus, you must use plain English principles in the organization, language, and design of the front and back cover pages, the summary, and the risk factors.
- (2) You must draft the language in these sections so that at a minimum it substantially complies with each of the following plain English writing principles:
  - (i) Short sentences;
  - (ii) Definite, concrete, everyday words;
  - (iii) Active voice;
  - (iv) Tabular presentation or bullet lists for complex material, whenever possible;
  - (v) No legal jargon or highly technical business terms; and
  - (vi) No multiple negatives.
- (3) In designing these sections or other sections of the prospectus, you may include pictures, logos, charts, graphs, or other design elements so long as the design is not misleading and the required information is clear. You are encouraged to use tables, schedules, charts and graphic illustrations of the results of operations, balance sheet, or other financial data that present the data in an understandable manner. Any presentation must be consistent with the financial statements and non-financial information in the prospectus. You must draw the graphs and charts to scale. Any information you provide must not be misleading.<sup>36</sup>

Drafting only the cover, the summary, and the risk factors section, if any, is a manageable way for an issuer to adjust to plain-English principles in the preparation of an official statement. The SEC's handbook on writing plain-English comments on the cover page of a prospectus, and the same comments apply to an official statement:

A cover page should be an introduction, an inviting entryway into your document, giving investors some key facts about your offering, but not telling everything all at once. If it looks dense

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36. 17 C.F.R. § 230.421(d).

and overgrown with thorny details, no one will want to pick it up and start reading. If it looks like a legal document written *by* lawyers and *for* lawyers, many investors will not even attempt to read it.

To create an inviting cover page, you'll need to strip away much of what is conventionally placed there, but which is not required.

As you review your cover page, question why each item of information is there. It may be important, but does it have to be on the cover page? You usually have a substantial document following the cover page—let some of those other pages carry the information load in logical order.

What would be helpful for investors to see on this page? Look through your investors' eyes and you'll make better decisions about where to place information.<sup>37</sup>

For example, on the cover page, some drafters are likely to write: "The 2009 Series A Bonds and the 2009 Series B Bonds (collectively, the '2009 Bonds') will be issued and secured under an Indenture of Trust, dated as of November 1, 2009, (the 'Indenture') by and between the Issuer and XYZ Bank, as trustee (the 'Trustee')." Instead, the cover page can state: "The trustee for both series of bonds is XYZ Bank." Information about the indenture of trust can be moved to the inside of the official statement. The aim is to provide concise information clearly in a manner that invites the potential investor to continue reading. The cover should not have long sentences describing, for example, the components of the trust estate.

The summary should orient the reader by highlighting the most important points that will be presented in greater detail later in the official statement. Lawyers have a propensity to consider the summary as a means of setting up all the defined terms, and the first paragraph is likely to be a deadly recitation of all the preceding series resolutions and their dates with clusters of resolutions formed to create defined terms. It is preferable to write the summary from the viewpoint of the investor and consider the main points the investor should know at the outset before reading the body of the official statement in greater detail. The SEC's guidance on plain English favors tables. If it is necessary to identify all of those old series resolutions, a table might be preferable to a one-sentence, hundred-word paragraph. Clusters of series resolutions, or series of bonds, can be identified by subheadings in the table rather than the typical sentence form: "The A resolution, the G resolution and the M resolution are hereinafter collectively

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37. SEC, A PLAIN ENGLISH HANDBOOK: HOW TO CREATE CLEAR SEC DISCLOSURE DOCUMENTS 12, *available at* [www.sec.gov](http://www.sec.gov).



referred to as the ‘Prior Taxable Bond Resolutions.’” Rule 421(b) directs prospectus writers to avoid frequent reliance on defined terms as a primary means of explaining information. A table to sort out a complicated list of prior resolutions is a visually useful means of identifying the information without relying on lengthy sentences. The SEC’s plain-English handbook advises:

Although customary, introducing defined terms on the cover page and in the summary discourages many readers from getting beyond the first pages. Overwhelmed with memorizing a new and unnatural vocabulary, and bothered by constantly having to flip back and hunt for the first time a defined term’s definition appears, many an investor will not stick with the document. One plain English expert has advised, don’t let a shortcut for the writer become a roadblock for the reader.<sup>38</sup>

The summary is also an appropriate section of the official statement to consider the use of personal pronouns. The SEC handbook provides a before-and-after sentence comparison to illustrate the introduction of personal pronouns in the summary:

before

This Summary does not purport to be complete and is qualified in its entirety by the more detailed information contained in the Proxy Statement and the Appendices hereto, all of which should be carefully reviewed.

after

Because this is a summary, it does not contain all the information that may be important to you. You should read the entire proxy statement and its appendices carefully before you decide how to vote.<sup>39</sup>

The SEC handbook makes the following case for personal pronouns:

No matter how sophisticated your audience is, if you use personal pronouns the clarity of your writing will dramatically improve. Here’s why.

First, personal pronouns aid your reader’s comprehension because they clarify what applies to your reader and what applies to you.

Second, they allow you to “speak” directly to your reader, creating an appealing tone that will keep your reader reading.

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38. *Id.* at 13.

39. *Id.* at 22.

Third, they help you to avoid abstractions and to use more concrete and everyday language.

Fourth, they keep your sentences short.

Fifth, first- and second-person pronouns aren't gender-specific, allowing you to avoid the "he or she" dilemma. The pronouns to use are first-person plural (we, us, our/ours) and second-person singular (you, your/yours).<sup>40</sup>

One reason the drafters of public finance official statements may be reluctant to try plain English is a belief that the entire document will have to be converted to plain English. Rule 421(d) makes clear that in registered offerings, the plain-English rule applies only to the cover, the summary, and the risk factors sections. Therefore, the use of personal pronouns may be inserted into the summary or the risk factor section, if any, while the remainder of the official statement is drafted in the customary form. There is no necessity to continue plain English as the official statement describes the terms of the bonds, the security, and the documents. Drafting risk factors will be discussed below, but assuming the official statement does not have a risk factors section, as is frequently the case, making an effort to use plain English on the cover and in the summary is not difficult and is likely to improve the document.

There is an important benefit to the drafter of the official statement in writing the summary in plain English. It forces the drafter to focus on the financing being described and not the offering document of another issuer, which is all too easy to copy. Marking up the summary of another issuer is a sure way to miss the big picture of the securities being issued. Drafting a summary should be seen as a due diligence exercise. It is an opportunity to give a brief explanation of the financing in an informal style. Writing the summary from scratch without marking up any document provides the drafter an opportunity to determine the issues that require further explanation in other sections of the official statement, and occasionally may uncover a red flag that prompts reconsideration of the underlying structure of the financing.

### **§ 8:3.2      *Drafting in Light of the TSC Industries Standard***

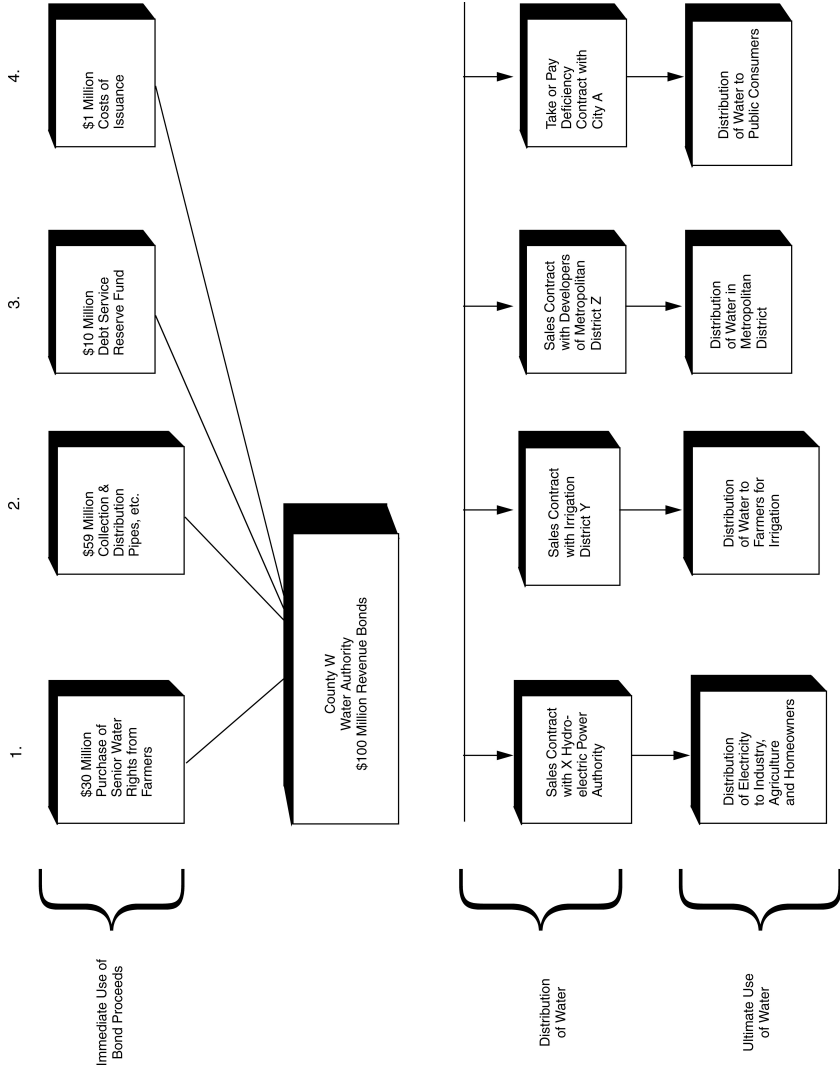
Chapter 14 describes the Supreme Court's definition of materiality from its opinion in *TSC Industries, Inc. v. Northway, Inc.*<sup>41</sup> A fact is material if there is a substantial likelihood that a reasonable investor

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40. *Id.*

41. *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976). *See also* *Basic Inc. v. Levinson*, 108 S. Ct. 978 (1988).

**FIGURE 8-1**  
**Water Marketing Financing**



would consider it important in deciding whether to purchase or sell securities. In chapter 14, it is explained that the Supreme Court's selection of the word "would" rather than "might" and the word "important" rather than some variation of the word "interesting" was a considered determination after the threshold standard of materiality was briefed by opposing counsel and had been previously described by use of various formulas developed in the lower courts. It is also suggested in chapter 14 that the Supreme Court's choice of words may have narrowed the range of material information, but it also imposes on the drafter of disclosure an obligation to review and edit information to make judgments as to what a reasonable investor would consider important. *TSC Industries* seeks to discourage plaintiffs from bringing frivolous lawsuits, while simultaneously promoting conscientious drafting of meaningful disclosure documents.

Illustrations in this area are difficult to articulate, because a description of a hypothetical situation lacks the essential wealth of detailed information that is likely to be present in real circumstances. With that precaution in mind, the transaction represented by Figure 8-1 may be considered. An arid western state creates a county water authority to engage in the marketing of water by purchasing water from suppliers outside the county and distributing it to consumers of water within the county in a manner that promotes efficient use. The authority proposes to issue \$100 million of bonds to finance the acquisition of water rights from distant farmers outside the county and the construction of water distribution systems both from outside sources to the authority's water holding facilities and from these facilities to the authority's consumers. The authority expects that the consumers will include a public power authority, which, in turn, has a supply contract to a private utility, a farmers' cooperative for irrigation distribution, a planned community in the early stages of development, and a city.

The issuer and lawyers preparing the official statement for this financing are unable to follow a predetermined format comparable to the SEC instructions for the filing of an S-1. The organization and extent of detail is a matter of judgment. Even the S-1 and Regulation S-K instructions on presentation of the "use of proceeds" are irrelevant to this water marketing financing. For example, Regulation S-K instructions are as follows: "State the principal purposes for which the net proceeds to the registrant from the securities to be offered are intended to be used . . . 2. Details of proposed expenditures need not be given."<sup>42</sup> If the issuer and the underwriters followed this general instruction in the water marketing financing, the official statement

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42. 17 C.F.R. § 229.504.

would contain significant material omissions. In the water financing, the use of proceeds is linked inextricably to the source of revenues and security for the bonds. Disclosure of the investments of the proceeds and of the ability of the structure to finance a redemption in the event the project proves unworkable is necessary. The legal rights of the farmers to market water and the quantity of water legally available for marketing should be discussed. The opinion of a recognized water attorney will probably be appended to the official statement. Likewise, the engineering and financial feasibility of the project may require the appending of a report of an engineering consultant experienced in major water distribution projects. These considerations lead to the primary issue of the extent of detail. If *TSC Industries* had announced a disclosure standard requiring all the information one "might" want to know, the amount of geological and hydrological information just in the "use of proceeds" section could be overwhelming. The actual standard, which is based on information a reasonable investor "would" want to know, helps to limit disclosure by suggesting that the consultant's report outline the premises leading to conclusions of feasibility and the methodology for determining the premises.

The question of detail is equally apparent on the distribution side of the water marketing enterprise. The water is to be marketed to a power authority, a cooperative for farm irrigation, a planned residential community, and a city. Each of these activities could result in its own fifty-page disclosure document if all that an investor "might" want to know were presented. By focusing on the "significant" information a reasonable investor "would" want to know, the issuer and lawyers should be led to organize the presentation around topics such as the overall demand for water in the county as illustrated by these anticipated users and the ability of the users to pay for the water in amounts sufficient to meet the coverage projections of the consultant. Particular attention will be given to the ability of the city to enter into a take-or-pay contract, and again a legal opinion of a recognized attorney may be referenced. The approach in *TSC Industries* suggests that in return for the effort required to sift through available information in order to make a significant presentation to the investor, the Supreme Court is willing to protect the issuer and underwriters from nuisance lawsuits based on speculative materiality.

Chapter 7 argues that dangerous consequences could follow from due diligence in public finance based on a checklist approach. Comparison of the water marketing financing to almost any other tax-exempt issue, such as that of a hospital or an airport, reveals that a checklist is equally inappropriate for disclosure. The law of public finance does not include statutes such as the Delaware Business Corporation Law that are generally applicable to issuers. In public

finance, legislation specific to each issuer is the norm. Similarly, while financial statements prepared in accordance with generally accepted accounting principles may tell much of the story of a for-profit business corporation, they often have nothing to say about a structured financing typical of public finance. Experienced issuers and lawyers who regularly prepare disclosure documents generally recognize the importance of diversity and disapprove of the application of simplistic mandatory disclosure requirements.<sup>43</sup> However, sudden events, such as the near financial collapse of New York City or the default of the Washington Public Power Supply System, result in proposals for item-oriented mandatory disclosure systems.<sup>44</sup> Interestingly, if the checklist proposed by Senator Williams in

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43. For example, in hearings before the Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs of the United States Senate regarding the Municipal Securities Full Disclosure Act of 1976, Donald J. Robinson, then a partner of Hawkins, Delafield & Wood, testified:

There will also be some very practical problems if either piece of legislation is enacted. These problems arise because of the diversity of types of municipal securities and governmental units. The U.S. Bureau of Census reported in 1972 that there were 78,267 State and local governmental units classified. When working on the Municipal Finance Officers Association guidelines, one of the major problems that was dealt with and why it took so long to at least come out with an exposure draft for something that people could comment on was the diversity of local laws, State and local laws. I understand fully the desire of the chairman in his bill to put together a set of guidelines and he's looked at the exposure draft of the MFOA and there's nothing in there that is dead wrong, but there is nothing in there that we know without comment, without review of all the comments from the 50 States, that is absolutely correct.

*Municipal Securities Full Disclosure Act of 1976: Hearings on S. 2969 and S. 2574 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, 94th Cong., 2d Sess. 232–33 (1976) [hereinafter S. 2969 Hearings]* (statement of Donald Robinson, Hawkins, Delafield & Wood).

44. In 1975, Senator Eagleton proposed repeal of the exemption from registration under section 3(a)(2). 121 CONG. REC. 38,796–800 (Dec. 5, 1975). In 1977, Senator Williams proposed mandatory registration, together with the filing by issuers with outstanding debt in excess of \$50 million of annual reports prepared in accordance with SEC rules. The Municipal Securities Full Disclosure Act of 1977, 123 CONG. REC. 38,236–47 (Dec. 1, 1977). The *S. 2969 Hearings* had considered an earlier version of the same bill. The default of the Washington Public Power Supply System prompted renewed discussion of the bill proposed by Senator Williams and consideration of the repeal of the Tower Amendment. See J. SELIGMAN, *THE SEC AND THE FUTURE OF FINANCE* 281–307 (1985); Remarks of David S. Ruder, Chairman, Securities and Exchange Commission, before the Public Securities Association (Oct. 23, 1987) (Disclosure in Municipal Securities Markets).

1977<sup>45</sup> were applied to the water marketing illustration, the official statement would contain virtually no significant disclosure.

45. See SELIGMAN, *supra* note 44, at 298 n.74 (quoting section 13A(b)(2) of the proposed Williams bill). S. 2969 would have required issuers having outstanding debt in excess of \$50 million to file annual reports containing the following information:

(A) An identification and description of the issuer of the securities outstanding; (B) A description of any legal limitation on the incurrence of indebtedness by the issuer or the taxing authority of the issuer; (C) A description of the issuer's debt structure, including information with respect to amounts of authorized and outstanding funded debt; estimated amount of short term debt, character of amortization provisions of funded debt, sinking fund requirements, security for debt, nature and extent of guaranteed debt, and debt service requirements; (D) A description of the nature and extent of other material contingent liabilities or commitments of the issuer; (E) If any payment of principal or interest on any security of the issuer or any predecessor thereof has been defaulted on, or has been postponed or delayed, within the past twenty years, a description of the date, amounts and circumstances of such event and of the terms of any succeeding arrangements thereof; (F) A description of the issuer's tax authority and structure over the past five years including the nature of taxes levied, tax rates, property (real and personal) valuation and assessment procedures, amounts of property valuations and assessments, amounts of tax levies, amounts of tax collections and delinquent tax procedures and experience; (G) A description of the issuer's major taxpayers; (H) A description of the principal governmental and other services provided or performed by the issuer, the extent to which similar or differing services are performed by other governmental entities which serve the same geographic area and any major changes in such services in the last ten years; (I) A description of the nature and extent of Federal or other assistance programs available to the issuer; and (J) Financial statements of the Issuer in such detail and form and for such periods beginning not earlier than the fifth previous fiscal year as the Commission may prescribe, which statements for any fiscal year commencing on or after December 31, 1978, shall be audited and reported on by an independent public or certified accountant in such manner as the Commission may prescribe.

S. 2969 *Hearings* at § 2(e).

Distributions of new securities additionally would include:

(A) A description of the offering, including amount to be offered, price, plan of distribution, and underwriting arrangements and compensation; (B) A description of the security to be offered, including provisions as to security, events of default, payment of principal and interest, sinking fund, redemption, debt reserve funds, priority, legality and authorization for issue and rights of security holders to bring suit against issuers; (C) A description of any project or enterprise of the issuer to be financed from the proceeds of revenue or special assessment securities, and any engineering or financial feasibility reports or studies on the construction and operations of the project or enterprise; (D) A description of the intended use of the

Figure 8-2 depicts a resource recovery financing marketed as a variable-rate demand obligation. The facility derives its revenues from (1) money paid pursuant to an “output contract” for the sale of electricity generated by a turbine driven by steam from the heat derived from the burning of garbage and (2) “tipping fees” paid by the municipalities for the contractual right to dump garbage at the facility. The sources of security may or may not include (1) a contractual obligation of the municipalities to pay “tipping fees” regardless of their delivery of garbage and regardless of the ability of the facility to receive garbage and (2) a “make-up” agreement by the vendor to pay debt service in the event the two sources of revenues derive an insufficient amount to pay debt service. This financing shares with the water marketing financing of Figure 8-1 a structure highly dependent on legal contracts. Nonetheless, both the “form” of the Figure 8-1 disclosure and any checklist approach to disclosure are entirely irrelevant to the Figure 8-2 financing. Disclosure for the resource recovery financing requires a complete understanding of the contractual relations that form the structure. Determination of what is material and what a reasonable investor “would” consider significant requires an ability to analyze the contracts with an appreciation of the needs of the investor. Likewise, the liquidity elements of the financing, including the put options and timing issues, must be drafted and disclosed in response to the negotiations among the credit and liquidity sources, the underwriters, issuer, vendor, and municipalities.

Lawyers and bankers frequently organize the drafting of an official statement by reference to prior official statements of the same issuer or other issuers in the same industry. An additional source of information is the website of the National Federation of Municipal Analysts (NFMA),<sup>46</sup> which provides online access to the NFMA series on Recommended Best Practices in Disclosure. For example, in the resource recovery project financing illustrated above, the working group drafting the official statement could review the NFMA Recommended Best Practices in Disclosure for Solid Waste Transactions. The guideline provides an industry background and an outline of the

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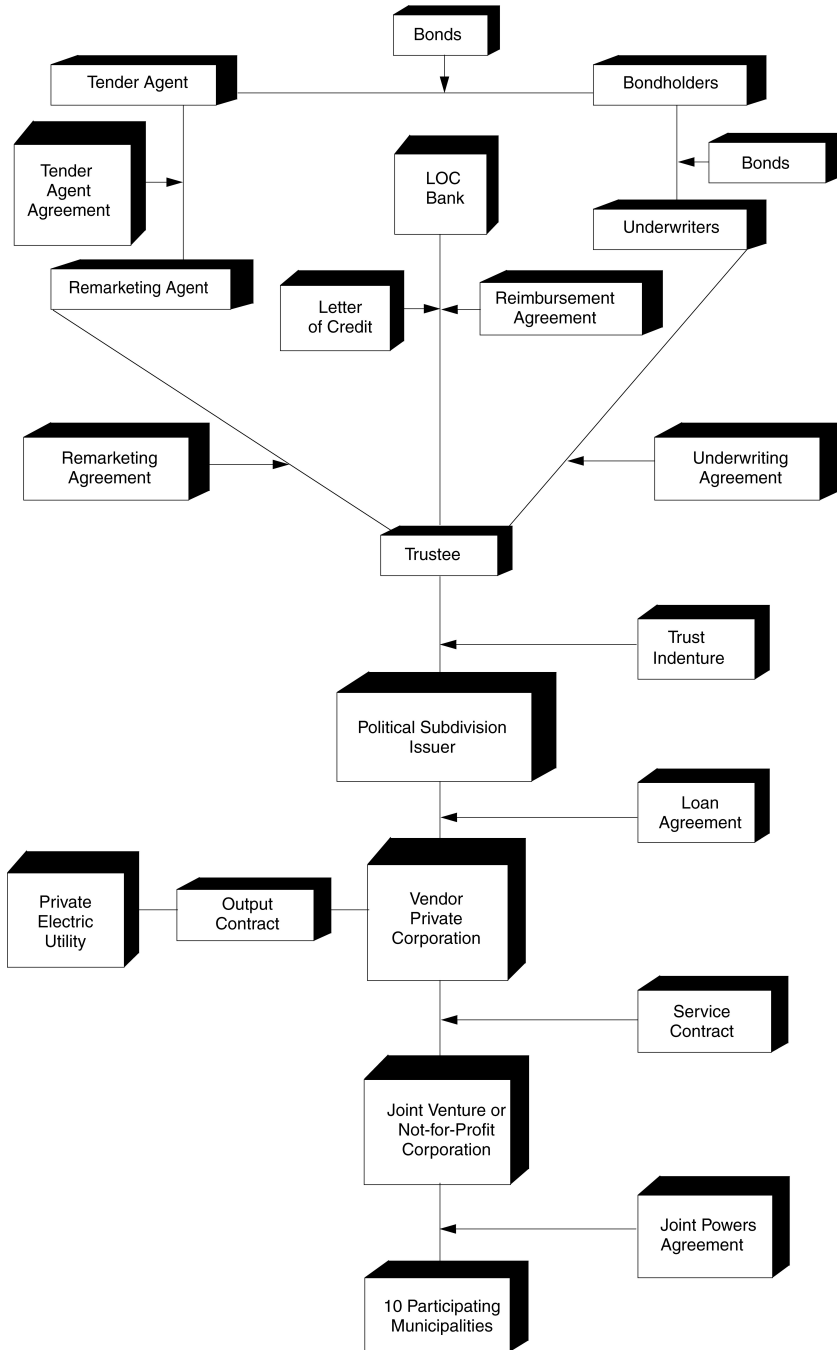
proceeds of the offering; (E) A statement of counsel’s opinion as to the legality of the issuance of the securities to be offered; (F) A statement of the availability of the reports required by this section; and (G) Such other similar and specific information as the Commission may by rules or regulations require as necessary or appropriate in the public interest or for the protection of investors.

*Id.*

46. [www.nfma.org](http://www.nfma.org).



**FIGURE 8-2**  
**Resource Recovery Variable-Rate Financing**



categories of information for disclosure consideration from the perspective of analysts and others who evaluate credits.<sup>47</sup> If individuals in the working group are preparing checklists or abbreviated checklists<sup>48</sup> for diligence or disclosure, websites for the Government Finance Officers Association,<sup>49</sup> the National Association of Bond Lawyers<sup>50</sup> and the Securities Industry Financial Markets Association,<sup>51</sup> in addition to the NFMA website, all provide online information useful for outlining facts that might be material. When information that “might” be material is evaluated in the context of a particular financing, the person drafting disclosure can then make judgments as to what “would” be material to a reasonable investor.

Both the water marketing and resource recovery financing cry out for summaries written in plain English. Diagrams, such as the figures used in this chapter to describe the financings, are useful and encouraged by the SEC in Rule 421(d)(3). The rule also recommends the use of pictures. Public finance abounds in new construction projects that can benefit from a visual presentation—from hospitals, museums, and sports facilities to public buildings, airports, and public power projects. Each of these suggestions can be considered a part of the editing responsibilities promoted by the Supreme Court in *TSC Industries*.

### **§ 8:3.3 Drafting “In Light of the Circumstances”**

The requirement in Rule 10b-5 that statements not be materially untrue or omit material information is modified by the phrase “in light of the circumstances.” Arguably, this phrase is redundant with the concept of materiality properly understood, but the phrase provides practitioners with an important reminder to consider the context of drafting disclosure. A material fact in one financing may be immaterial in another because the circumstances of the disclosure are different. Differences in the audience for the disclosure are a simple illustration of differences in contextual circumstances. Materiality for a retail market may vary significantly from materiality for an institutional market and, therefore, the drafter of an official statement should routinely consider the likely range of readers of the document.

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47. NFMA, *Recommended Best Practices in Disclosure for Sold Waste Transactions* (Nov. 2001), [www.nfma.org](http://www.nfma.org).

48. For a description of checklists that evolve as the preparation of underlying documents and the official statement progress, see section 7:5.1[C].

49. [www.gfoa.org](http://www.gfoa.org).

50. [www.nabl.org](http://www.nabl.org).

51. [www.sifma.com](http://www.sifma.com).

### **[A] Commercial Paper and Variable-Rate Demand Obligations**

The context of materiality includes variations in the credit structure of a financing. Material information about an issuer in one financing may be immaterial information about an apparently similar issuer in a contemporaneous financing. For example, a state finds it necessary to finance a structural imbalance in its budget by engaging in deficit financing. The disclosure will probably include a discussion of the current budget deficit, proposals for closing the budget gap, projections for the period the securities are vulnerable to deficiencies, the security of the bonds or notes, and economic factors supporting the security of the bonds or notes. Even if the maturity of the securities is short- or medium-term, the disclosure of material information is likely to be extensive.

Another state issuer has a seasonal budget imbalance and determines to issue tax-exempt commercial paper under statutory provisions authorizing tax and revenue anticipation notes. The principal of and interest on the notes are secured by an irrevocable direct pay letter of credit. The budget gap for this state represents the ordinary imbalance in the timing of required expenditures and the receipt of revenues. The note issue is comparable to traditional commercial paper in which a manufacturing or industrial company finances the gaps between accounts payable for raw materials and receipts for finished products. Banks viewed the commercial paper as secured by the value of the product in the business cycle. Rather than an investment in a company, business cycle financing was considered a commercial product, and the 1934 Act accordingly excluded it from the definition of a security.<sup>52</sup> Likewise, when commercial paper was sold to institutional investors through underwriters, rather than negotiated with a commercial bank, the disclosure document was limited to a dealer memo summarizing terms. In the illustration, the

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52. Section 3(a)(10) of the 1934 Act defines a “security” for purposes of the 1934 Act and excludes from the definition specific commercial products: “[The term ‘security’] shall not include currency or any note, draft, bill of exchange, or banker’s acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.” The drafting of the 1933 Act is markedly different. The definition of “security” in section 2(a)(1) does not have a specific exclusion for commercial products, but section 3(a)(3) of the 1933 Act exempts commercial paper from the registration requirements of section 5. There is no exemption for commercial paper from the antifraud provisions of section 17 of the 1933 Act. See *Reves v. Ernst & Young*, 494 U.S. 56 (1990), for differing views of the justices on whether promissory notes are securities and the dissenting opinion of Justice Stevens that the definitions in the 1933 Act and the 1934 Act should be read similarly.

commercial paper is financing the business cycle of the state, and the credit support of the letter of credit emphasizes the commercial quality of the transaction. It follows that a practitioner could reasonably conclude that a short form of disclosure is justified "in light of the circumstances." For example, a statement could be made in the disclosure document to the effect that purchasers of the commercial paper should not rely on the state to pay the commercial paper at maturity but should make a purchase decision solely on the creditworthiness of the bank issuing the letter of credit. The disclosure emphasis would then shift from the state to the bank, because the circumstances justify viewing material information as based on the bank's credit. The resemblance to the state financing an end-of-year deficit is superficial, and the disclosure requirements are readily distinguishable.

In 1988, the SEC stated that the presence or absence of credit enhancements would be a factor in determining the reasonableness of a municipal underwriter's basis for assessing the truthfulness of the key representations in final official statements.<sup>53</sup> This view was modified in 1989 by the SEC's conclusion that the presence of credit enhancements does not foreclose the need for a reasonable investigation of the accuracy and completeness of key representations concerning the primary obligor.<sup>54</sup> The SEC extended the need for a reasonable investigation to disclosure: "In the Commission's view, the presence of credit enhancements *generally* would not be a substitute for material disclosure concerning the primary obligor on municipal *bonds*."<sup>55</sup> The SEC refers to the possibility of default of the primary obligor as one reason for disclosure, because a default would affect the price of the bonds. It is suggested that the circumstances in the illustration above represent a situation in which it is unnecessary to have disclosure on the primary obligor. The letter of credit, a commercial product, is securing commercial paper, another commercial product. Principal and interest on the commercial paper are to be paid by the bank under a direct-pay letter of credit. The underlying note is sized by reference to tax and revenue receivables. The note is not exposed to the credit risk of a long-term bond. The short-term nature of the paper also substantially reduces the risk of a bank default. Therefore, the drafter of the disclosure document should be in a position to conclude that the circumstances of the commercial paper offering allow for a modification of the SEC's general conclusion that primary obligor disclosure is material.

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53. Exchange Act Release No. 26,100, text following n.87 (Sept. 22, 1988).

54. Exchange Act Release No. 26,985, text following n.90 (July 10, 1989).

55. *Id.*, text at n.89 (emphasis added).

Variable-rate demand obligations have features that are similar to commercial paper backed by a letter of credit. The typical variable-rate demand obligation is supported by an irrevocable direct-pay letter of credit, and, while the stated maturity is long term, the holder has the right to put the bond to the issuer for repurchase at a price of par plus accrued interest at stated intervals related to the intervals for setting interest rates (daily, weekly, monthly, etc.). In the form most closely paralleling commercial paper, a mandatory tender for repurchase at stated intervals (usually not exceeding 270 days) is substituted for the optional put. The variable-rate demand obligation does not have the history of commercial paper that corresponds to the business cycle of a company and disclosure limited to a dealer memo summarizing terms, but the credit analysis may (depending on the details of the structure) be similar. If there is an irrevocable direct-pay letter of credit, and it provides liquidity as well as credit support, the credit analysis will focus on the bank providing the letter of credit, and reasonable disclosure should provide information about the bank and describe the financing, including details on the method for setting interest rates and the process for exercising the put option and receiving payment from the letter of credit bank. If liquidity is provided by another source, and there are contractual conditions allowing for termination of the liquidity facility, the entire “circumstances” of disclosure change.<sup>56</sup>

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56. Market conditions may affect the acceptability of “short-form” disclosure regardless of the legal analysis. Thus, in a 2008 paper released by NABL, the question of disclosure was addressed in the event auction rate securities were converted to variable-rate securities:

Most counsel take the position that a variable rate demand obligation that (1) is supported by a direct-pay letter of credit, which provides credit and liquidity support, (2) may be tendered by the holder at any time upon short notice (generally seven days), (3) for which disclosure is made that the prospective investor should look only to the provider of the credit and liquidity support in making its investment decision whether to purchase the bonds, may be sold pursuant to a “short-form” Official Statement that contains little (if any) information concerning the underlying obligor. On the other hand, (A) the SEC staff has expressed the view, most recently in testimony provided by the Director of the Division of Trading and Markets to Congress on February 14, 2008, that “the presence of credit enhancements are generally not a substitute for material disclosure concerning the primary obligor on municipal bonds,” and (B) certain investment banking houses, in light of recent market events, are not accepting the short-form disclosure documents if they are acting as remarketing agent.

John McNally & Ed Oswald, *Commonly-Asked Questions Regarding Securities and Tax Implications of Auction Rate Bond Market Turmoil* (Feb. 29, 2008), available at [www.nabl.org](http://www.nabl.org).

The circumstances are also different in the case of a long-term bond issue that has credit enhancement in the form of bond insurance. The bond insurance is not the source of payment of debt comparable to a direct-pay letter of credit. Bond insurance provides security in the event the issuer fails to pay, and its existence does not substantially affect the materiality of information about the issuer and the primary sources of payment for the principal and interest on the bonds. Disclosure for a financing with bond insurance will probably be the same as disclosure for the financing if there were no bond insurance, except for the additional disclosure necessary to describe the insurance. Thus, the SEC rejected the argument by the City of Miami that the failure to disclose the city's cash flow crisis in three 1995 official statements was not material because bond insurance gave the bonds a triple-A rating by the rating agencies. In its review of a decision against Miami by an administrative law judge, the SEC summarily concluded: "Bond insurance did not give Miami license to misrepresent its financial condition or withhold material information from the marketplace."<sup>57</sup>

### **[B] Variable-Rate Obligations and Short-Term Securities Sold to Money Market Funds**

The antifraud language that limits disclosure to facts that are material "in light of the circumstances" is a legal standard. However, there may be marketing circumstances that suggest drafting information required by a class of buyers as a prerequisite to the securities being included in their portfolios. The information may not be material "in light of the circumstances" as a legal matter for disclosure by the issuer, but it is appropriate for the issuer and underwriters to consider providing such information if it improves demand for the securities being distributed.

If the purchaser of securities is an investment company under the 1940 Act, the purchaser itself is subject to the antifraud provisions of the 1940 Act, including section 34, which makes it unlawful for any person filing a registration statement or other document to omit facts necessary to make the statements made, "in light of the circumstances" under which they were made, not misleading. Money market funds are significant investors in variable-rate and short-term tax-exempt securities, but sponsors of the funds are constrained in the securities that may be included in the funds by reason of Rule 2a-7 adopted by the SEC under the 1940 Act. Rule 2a-7 provides that it is an untrue statement of material fact pursuant to section 34 if an investment company holds itself out as a money market fund unless it

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57. *In re* City of Miami, Florida, Cesar Odio and Manohar Surana, SEC Cease-and-Desist Order, Securities Act Release No. 8213 (Mar. 21, 2003).

complies with the substantive requirements of specified provisions of Rule 2a-7. The money market fund therefore requires sufficient information to meet its antifraud legal obligation.

Money market funds are invested in high-quality short-term securities and compete with low-risk, high-liquidity bank deposit products.<sup>58</sup> The funds are structured to avoid daily fluctuations in market value by seeking to maintain a stable net asset value per share. Any increase in the value of a shareholder's investment is reflected in additional shares rather than an increase in net asset value per share, and the funds use either of two valuation methods to maintain a stable net asset value: amortized cost or penny rounding.<sup>59</sup>

Using amortized cost or penny rounding valuation to maintain a stable net asset value is inconsistent with general mark-to-market methods required by section 2(a)(41) of the 1940 Act, and the SEC, accordingly, found it necessary to adopt Rule 2a-7 to allow the alternative valuation in order for money market funds to have stability of value comparable to competing bank products. Rule 2a-7 has strict requirements with respect to credit quality, portfolio diversification, effective maturity, and security structure. A portfolio manager for a money market fund requires information that allows a determination that an issue of variable-rate or short-term securities qualifies under Rule 2a-7, and some of this information has not traditionally been included in the offering memorandum or other disclosure document for variable-rate and short-term tax-exempt securities. In addition, the portfolio manager of a money market fund is required under Rule 2a-7 to maintain surveillance of the portfolio to verify continued compliance with the rule. However, many securities that qualify to be included in tax-exempt money market funds also qualify for exemption from the continuing disclosure requirements of Rule 15c2-12.<sup>60</sup>

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58. For a description of tax-exempt money market funds, the extensive holdings in such funds, and the implications of Rule 2a-7 under the 1940 Act, see P. Maco, *Federal Securities Regulation*, THE BOND LAWYER (June 2 and Dec. 1, 2001), [www.nabl.org](http://www.nabl.org).

59. Amortized cost valuation calculates net asset value by reference to acquisition cost, as adjusted for amortization of premium or accumulation of discount, and penny rounding valuation allows net asset value to be rounded to the nearest cent. See Rules 2a-7(a)(1) and 2a-7(a)(2) under the 1940 Act.

60. Rule 15c2-12 exempts offerings of municipal securities in authorized denominations if the maturity is nine months or less or the purchaser has a tender option to an issuer at least as frequently as every nine months. It follows that many offerings of commercial paper, variable-rate securities, and short-term securities are exempt under the rule. Rule 15c2-12 is set forth in Appendix 6B.

In order to assist issuers drafting disclosure documents expected to be sold to money market funds, the National Federation of Municipal Analysts (NFMA) in 2002 released a draft statement of *Recommended Best Practices in Disclosure for Variable Rate and Short-Term Securities*.<sup>61</sup> The majority of primary market disclosures necessary for the portfolio manager to determine whether a new issue of municipal securities qualifies under Rule 2a-7 for a money market fund relate to the terms of the financing. For example, if there is a “demand feature” (an optional put), Rule 2a-7 requires that the exercise price for repurchase approximate amortized cost (generally par) plus accrued interest in order to maintain the stability of the fund at amortized cost. In addition, the notice period to exercise the put cannot exceed thirty days. Price stability is also achieved by diversification of portfolio assets. Rule 2a-7 imposes strict rules on the percentage of a portfolio invested in any issuer, and the rule recognizes the significance of “conduit securities” issued by a “municipal issuer.” Diversification rules also apply to the letter of credit provider in a variable-rate demand obligation, and the rules are stricter if there is a “control relationship” between the bank and the obligor. For the portfolio manager to make a “control relationship” determination, the NFMA requests that the issuer’s disclosure include an affirmative statement with respect to any relationship between the bank and the obligor.

The continuing disclosure necessary for the portfolio manager to monitor the fund includes notification of any rating downgrade, any change in the letter of credit provider, and any default or event of insolvency. These categories of information are likely to be covered by the material-event notice provisions of Rule 15c2-12, but, as stated above, the variable-rate or short-term securities qualifying as eligible securities under Rule 2a-7 are likely to be exempt from Rule 15c2-12. If the issuer agrees to voluntary continuing disclosure to promote marketing to the funds, the issuer could limit the voluntary continuing disclosure to the Rule 15c2-12 material-event notice without volunteering the disclosure of annual financial information. The material-event notice, in turn, could be modified to reflect more closely the language contained in Rule 2a-7.

### **§ 8:3.4      *Drafting Forward Statements in Public Finance***

#### **[A]      *Projections and Estimates***

The importance of projections in public finance to provide material information in an official statement may be illustrated by consideration of the construction of a project financed with revenue bonds. In

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61.      NFMA, *Recommended Best Practices in Disclosure for Variable Rate and Short-Term Securities* (May 2002), [www.nfma.org](http://www.nfma.org).



general, the security of a revenue bond financing is the adequacy of the flow of revenues to

- (1) maintain the operation of the project that generates the revenues,
- (2) cover debt service on the bonds,
- (3) provide sufficient amounts to repair and renew the project during the life of the bonds, and
- (4) maintain reserve funds at their required amounts.

The investor in long-term revenue bonds is likely to require sufficient information to be reasonably satisfied that the future flow of revenues is likely to achieve these purposes at a coverage level that allows a cushion for risk.

If the revenue bond financing is for the construction of a new project, or the extension of an existing project, the revenues for the payment of the bonds may be derived in large part from the new construction, and historical performance will not necessarily be an accurate indicator of future revenues. For example, a water and sewer authority is issuing revenue bonds to extend its water and sewer system to rural areas of its jurisdiction where new home construction is expected during the succeeding five years. The existing system provides revenues for the purposes described above at a level sufficient to achieve two times debt service coverage, but the debt service on the new revenue bonds could not be supported without revenues being substantially increased as a result of the extension of the system. Material information in the official statement therefore cannot be limited to historical performance of the water and sewer authority, but requires forward projections to give the potential investor a basis for evaluating future performance of the system.

Prior to 1979, the SEC discouraged the use of projections and estimates in disclosure documents on the theory that they were not material "facts," and start-up companies were likely to be overly optimistic about profit potential.<sup>62</sup> In 1979, the SEC concluded that management's superior position in accessing data and evaluating the business meant that their judgment of future performance was material. Rule 175 and Rule 3b-6 were therefore promulgated to encourage disclosure of insider projections in SEC filings by providing a safe harbor "unless it is shown that such statement was made . . . without a reasonable basis or was disclosed other than in good faith." The safe

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62. Schneider, *Safe Disclosure: Thrusts and Parries When Bad News Follows Optimistic Statements*, 26 REV. SEC. & COMMODITIES REG. 33 (1993); Eisenberg, *Liability for Faulty Earnings Projections and Optimistic Statements*, 21 SEC. REG. L.J. 202 (1993).

harbor, however, applies only to documents filed with the SEC in a registration pursuant to the 1933 Act or by reporting companies making filings pursuant to the 1934 Act. The SEC's safe harbor is therefore not available to issues of municipal securities (other than those in which the underlying obligor is a 1934 Act reporting company), and projections in public finance will be tested under rules developed by the courts rather than SEC Rule 175 or 3b-6.<sup>63</sup>

The enforcement action against the City of San Diego illustrates the importance attached by the SEC to disclosure of currently known facts about future expectations.<sup>64</sup> The official statements containing allegedly misleading information were delivered in 2002 and 2003, and the expectations the SEC found to be wanting related to the years following through 2009. Each of the charges listed by the SEC in the cease-and-desist order related to failures in making proper forward statements about the gravity of the city's problems in funding its pension and retiree healthcare obligations:

- The City's unfunded liability to its pension plan *was expected to* dramatically increase, growing from \$284 million at the beginning of fiscal year 2002 and \$720 million at the beginning of fiscal year 2003 to an *estimated* \$2 billion at the beginning of fiscal year 2009;
- The City's total under-funding of the pension plan *was also expected to* increase dramatically, growing tenfold from \$39.2 million in fiscal year 2002 to an *estimated* \$320 to \$446 million in fiscal year 2009;

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63. See Rule 175 under the 1933 Act and Rule 3b-6 under the 1934 Act. Securities Act Release No. 6084, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,117 (June 25, 1979). Rules 175 and 3b-5 define forward-looking statements as follows:

- (c) For the purpose of this rule, the term "forward looking statement" shall mean and shall be limited to:
- (1) A statement containing a projection of revenues, income (loss), earnings (loss) per share, capital expenditures, dividends, capital structure or other financial items;
  - (2) A statement of management's plans and objectives for future operations;
  - (3) A statement of future economic performance contained in management's discussion and analysis of financial condition and results of operations included pursuant to Item 303 of Regulation S-K or Item 9 of Form 20-F; or
  - (4) Disclosed statements of the assumptions underlying or relating to any of the statements described in paragraph (c)(1), (2), or (3) above.

64. *In re* City of San Diego, Cal., SEC Cease-and-Desist Order, Securities Act Release No. 8751 (Nov. 14, 2006).

- The City's projected annual pension contribution would *continue to grow*, from \$51 million in 2002 to \$248 million in 2009; and
- The *estimated present value* of the City's liability for retiree health benefits was \$1.1 billion.<sup>65</sup>

### [B] Bespeaks-Caution Doctrine

Aside from SEC rulemaking, the federal courts of appeals have been developing the “bespeaks-caution” doctrine that economic projections, estimates of future performance, and similar forward-looking statements in a disclosure document are not actionable when meaningful cautionary language elsewhere in the document adequately discloses the risks involved.<sup>66</sup> The Supreme Court has not specifically referenced the bespeaks-caution doctrine, but in *Virginia Bankshares, Inc. v. Sandberg*,<sup>67</sup> the Court stated one premise of the doctrine:

While a misleading statement will not always lose its deceptive edge simply by joinder with others that are true, the true statements may discredit the other one so obviously that the risk of real deception drops to nil . . . [Therefore,] publishing accurate facts . . . can render a misleading proposition too unimportant to ground liability.<sup>68</sup>

The Supreme Court's opinion in *Virginia Bankshares* emphasizes the importance of context in reviewing disclosure. This view was subsequently stated directly by the Fifth Circuit in *Rubinstein v. Collins*.<sup>69</sup>

In essence, predictive statements are just what the name implies: predictions. As such, any optimistic projections contained in such statements are necessarily contingent. Thus, the “bespeaks caution” doctrine has developed to address situations in which optimistic projections are coupled with cautionary language—in particular, relevant specific facts or assumptions affecting the

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65. *Id.* (emphasis added).

66. *See, e.g., In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407 (9th Cir. 1994); *Rubinstein v. Collins*, 20 F.3d 160 (5th Cir. 1994); *Kline v. First W. Gov't Sec., Inc.*, 24 F.3d 480 (3d Cir. 1994); *Sinay v. Lamson & Sessions Co.*, 948 F.2d 1037 (6th Cir. 1991); *I. Meyer Pincus & Assocs. v. Oppenheimer & Co.*, 936 F.2d 759 (2d Cir. 1991); *Romani v. Shearson Lehman Hutton*, 929 F.2d 875 (1st Cir. 1991); *Luce v. Edelstein*, 802 F.2d 49 (2d Cir. 1986); *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357 (3d Cir. 1993).

67. *Va. Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 111 S. Ct. 2749 (1991).

68. *Id.* at 1097, 111 S. Ct. at 2760–61.

69. *Rubinstein v. Collins*, 20 F.3d 160 (5th Cir. 1994).

reasonableness of reliance on and the materiality of those projections. To put it another way, the “bespeaks caution” doctrine reflects the unremarkable proposition that statements must be analyzed in context.<sup>70</sup>

The doctrine allows a means for the federal courts to rule as a matter of law that the cautionary statements protect the defendant from liability for a projection that is not realized. Defendants can raise the doctrine in a motion to dismiss without bearing the expense of trial and prolonged discovery.<sup>71</sup> In 1988, Taj Mahal Funding Inc. issued \$675 million of bonds to finance a casino/hotel on the boardwalk in Atlantic City, New Jersey.<sup>72</sup> The proceeds were loaned to a limited partnership to construct a casino that was twice the size of any other casino in Atlantic City. The financing was similar to a new construction revenue bond issue in public finance because the security of the bondholders was effectively limited to the revenues of the project being financed and the mortgage on the project. The revenues proved to be insufficient, and defendants filed for a Chapter 11 reorganization plan in bankruptcy.

Plaintiff’s complaint emphasized a statement in the management discussion and analysis section of the prospectus: “The Partnership believes that funds generated from the operation of the Taj Mahal will be sufficient to cover all of its debt service (interest and principal).”<sup>73</sup> Plaintiffs argued that defendants’ statement of belief was materially misleading, and defendants countered that plaintiffs could not claim to be misled when there was an abundance of cautionary language.<sup>74</sup>

In referring to the cautionary language, the Third Circuit concluded:

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70. *Id.* at 167.

71. Langevoort, *Disclosures That “Bespeak Caution,”* 49 BUS. LAW. 481, 482 (1994).

72. *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357 (3d Cir. 1993).

73. *Id.* at 366.

74. The following are three of six disclosures referenced by the court that are cited as cautionary statements giving context to the adequacy of revenues to cover debt service:

The Taj Mahal has not been completed and, accordingly, has no operating history. The Partnership, therefore, has no history of earnings and its operations will be subject to all of the risks inherent in the establishment of a new business enterprise. Accordingly, the ability of the Partnership to service its debt to [Taj Mahal Funding Inc., which issued the bonds,] is completely dependent upon the success of that operation and such success will depend upon financial, business, competitive, regulatory and other factors affecting the Taj Mahal and the casino industry in general as well as prevailing economic conditions . . . .

The prospectus clearly and precisely cautioned that the bonds represented an exceptionally risky, perhaps even speculative, venture and that the Partnership's ability to repay the bonds was uncertain. Given this context, we believe that no reasonable jury could conclude that the subject projection materially influenced a reasonable investor.<sup>75</sup>

The cautionary language was sufficiently extensive and specific to dilute the expression of opinion that revenues would be sufficient to cover debt service. The opinion read in context is not misleading because a reader could readily determine that "any such optimism was more an expression of hope than considered judgment."<sup>76</sup> It was unnecessary for the court to consider the state of mind of the partners in expressing the opinion, because the opinion was rendered immaterial when read in context. Note that the footnoted bullet points from *Trump Casino* are drafted as risk factors. Well-drafted risk factors, discussed in the next section, are a form of cautionary statements within the bespeaks-caution doctrine.

*Trump Casino* should not, however, lead to an inference that cautionary statements can be drafted to shield misleading statements, giving issuers a license to make projections that are unreasonably optimistic. Unfortunately, the Third Circuit's opinion can be read to imply otherwise as suggested in the following two statements:

[W]e think it clear that the accompanying warnings and cautionary language served to negate any potentially misleading effect that the prospectus' statement about the Partnership's belief in its ability to prepay the bond would have on a reasonable investor.<sup>77</sup>

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The Taj Mahal will be the largest casino/hotel complex in Atlantic City, with approximately twice the room capacity and casino space of many of the existing casino/hotels in Atlantic City. [No] other casino/hotel operator has had experience operating a complex the size of the Taj Mahal in Atlantic City. Consequently, no assurance can be given that, once opened, the Taj Mahal will be profitable or that it will generate cash flow sufficient to provide for the payment of the debt service. . . .

Competition in the Atlantic City casino/hotel market is intense. At present, there are twelve casino/hotels in Atlantic City . . . . Some Atlantic City casino/hotels recently have completed renovations or are in the process of expanding and improving their facilities . . . . The Partnership believes that, based upon historical trends, casino win per square foot of casino space will decline in 1990 as a result of a projected increase in casino floor space, including the opening of the Taj Mahal.

*Id.* at 370.

75. *Id.* at 373.

76. Langevoort, *supra* note 71, at 500.

77. *Trump Casino*, 7 F.3d at 373.

The linchpin of the district court's decision was what has been described as the "bespeaks caution" doctrine, according to which a court may determine that the inclusion of sufficient cautionary statements in a prospectus renders misrepresentations and omissions contained therein nonactionable.<sup>78</sup>

Cautionary statements should not be viewed as shielding misleading statements. Rather, the projection or opinion should be considered not misleading when properly read in the context of other disclosures. Alternatively, the isolated sentence containing the opinion could be determined to be immaterial in the light of extensive and specific cautionary statements, or it could be concluded that in reading the "total mix" of information, there are no material misstatements. In considering the bespeaks-caution doctrine, the practitioner should not infer from the cases that there is an expression of leniency toward isolated misstatements. On the contrary, the bespeaks-caution doctrine is intended to promote meaningful, carefully drafted projections when projections are appropriate for complete disclosure. In making projections, the drafter should consider whether cautionary statements are necessary to provide context for the projections, and the preferable practice would be to attempt to draft the projections and the cautionary statements together so that it would be unreasonable for the reader to separate the projection from the context.

The emphasis on context in the cases developing the bespeaks-caution doctrine should also lead to recognition that there is a difference between projections made by seasoned reporting companies and projections made by startup companies. Earnings forecasts by management of a major corporation are highly material information, and investors reasonably rely on such projections. Since the materiality of forecasts by sophisticated management rises, the likelihood of cautionary statements rendering the forecasts immaterial is significantly reduced.<sup>79</sup> The bespeaks-caution doctrine is less applicable to highly developed markets than to markets such as a speculative real estate development, as illustrated by *Trump Casino*. This variation in the application of the bespeaks-caution doctrine applies equally to public finance. There are well-seasoned public corporations with management capable of projecting revenues that will represent material information to investors in their municipal securities. On the other hand, for many issuers of municipal securities, management is less capable of making accurate forecasts, or circumstances make it

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78. *Id.* at 364. It should be noted, however, that this language in *Trump Casino*, treating the isolated sentence under review as misleading, is similar to the language of the U.S. Supreme Court in *Virginia Bankshares* quoted above in the text at note 68.

79. Langevoort, *supra* note 71, at 502.

difficult to project with accuracy. In these situations, the materiality of the projection declines, the materiality of the cautionary statements increases, and the bespeaks-caution doctrine becomes more significant.

### [C] PSLRA Safe Harbor

In 1995, Congress enacted the Private Securities Litigation Reform Act (PSLRA or the Reform Act).<sup>80</sup> The Reform Act creates a safe harbor<sup>81</sup> applicable to any private action<sup>82</sup> under the 1933 or the 1934 Act in which the claim is based on a misleading statement of material fact relating to a forward-looking statement.<sup>83</sup> The safe harbor applies to issuers that are reporting companies under section 13(a) or 15(d) of the 1934 Act. Accordingly, the statutory safe harbor has limited application to public finance, but the statutory language was informed by the bespeaks-caution doctrine developed by the courts, and the bespeaks-caution doctrine is likely to be informed by the statute. Practitioners in public finance drafting disclosure documents should therefore be familiar with the safe harbor contained in the Reform Act.

There are three safe harbors in the Reform Act for forward-looking statements:

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80. Pub. L. No. 104-67, 109 Stat. 737 (1995).
  81. The safe harbor for forward-looking statements is set forth in section 27A of the 1933 Act and section 21E of the 1934 Act.
  82. The Reform Act safe harbor does not apply to SEC enforcement actions or Justice Department criminal proceedings, but the bespeaks-caution doctrine, which is an interpretation of the antifraud provisions of the 1933 and 1934 Acts, does apply to such actions and proceedings.
  83. The Reform Act defines a "forward-looking statement" as follows:
    - (A) A statement containing a projection of revenues, income (including income loss), earnings (including earnings loss) per share, capital expenditures, dividends, capital structure, or other financial items;
    - (B) A statement of the plans and objectives of management for future operations, including plans or objectives relating to the products or services of the issuer;
    - (C) A statement of future economic performance, including any such statement contained in a discussion and analysis of financial condition by the management or in the results of operations included pursuant to the rules and regulations of the Commission;
    - (D) Any statement of the assumptions underlying or relating to any settlement described in subparagraph (A), (B), or (C);
    - (E) Any report issued by an outside reviewer retained by an issuer, to the extent that the report assesses a forward-looking statement made by the issuer; or
    - (F) A statement containing a projection or estimate of such other items as may be specified by rule or regulation of the Commission.

1. The forward-looking statement “is identified as a forward-looking statement, and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those projected in the forward-looking statement.”
2. The forward-looking statement is “immaterial.”
3. The plaintiffs fail to prove as to a natural person defendant that the forward-looking statement was made “with actual knowledge by that person that the statement was false or misleading.” In the case of a business entity, the plaintiffs fail to prove that the statement was “made by or with the approval of an executive officer” and that such officer had “actual knowledge . . . that the statement was false or misleading.”

The Conference Report<sup>84</sup> accompanying the bill that became the Reform Act contains the following statement on the first of the three safe harbors:

The first prong of the safe harbor protects a written or oral forward-looking statement that is: (i) identified as forward-looking, and (ii) accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those projected in the statement.

Under this first prong of the safe harbor, boilerplate warnings will not suffice as meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those projected in the statement. The cautionary statements must convey substantive information about factors that realistically could cause results to differ materially from those projected in the forward-looking statement, such as, for example, information about the issuer’s business.

As part of the analysis of what constitutes a meaningful cautionary statement, courts should consider the factors identified in the statements. “Important” factors means the stated factors identified in the cautionary statement must be relevant to the projection and must be of a nature that the factor or factors could actually affect whether the forward-looking statement is realized.

The Conference Committee expects that the cautionary statements identify important factors that could cause results to differ materially—but not all factors. Failure to include the particular factor that ultimately causes the forward-looking statement not to

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84. CONFERENCE REPORT TO ACCOMPANY H.R. 1058, H.R. REP. NO. 104-369, as reprinted in 1995 U.S.C.C.A.N. 730.



come true will not mean that the statement is not protected by the safe harbor. The Conference Committee specifies that the cautionary statements identify “important” factors to provide guidance to issuers and not to provide an opportunity for plaintiff counsel to conduct discovery on what factors were known to the issuer at the time the forward-looking statement was made.<sup>85</sup>

The reference to “meaningful cautionary statements” in the Reform Act and the Conference Report is derived from the Third Circuit’s opinion in *Trump Casino* described in the preceding section.<sup>86</sup> Likewise, the reference in the Conference Report to the inadequacy of boilerplate cautions is derived from *Trump Casino*, but the Third Circuit’s further statement in that case that the cautionary statements must be “tailored to the specific future projections”<sup>87</sup> is omitted from the Conference Report. Instead, the Conference Report requires that the cautionary statements identify “important factors.” The change from “tailored” to “important” is apparently in keeping with the Reform Act’s policy of preventing unreasonable strike suits. If plaintiff’s counsel is able to identify a subsequent event that contributes to a projection’s not being realized, and that was not referenced in the cautionary statements, plaintiff’s counsel could challenge the adequacy of the drafting. By referring to “important factors,” the Conference Report makes clear to the courts that if meaningful cautionary statements are disclosed, a motion to dismiss can properly be granted even if a subsequent event occurs that was not drafted into the cautionary statements. From the perspective of the practitioner drafting disclosure, however, the Conference Report should not be read as encouraging boilerplate, general cautionary statements. When a projection is prepared, any accompanying cautionary statements should be drafted in a manner that is meaningful to the specific projection.

In its 2012 Report on the Municipal Securities Market, the SEC emphasized the importance of “forward-looking or trend information regarding a municipal issuer or obligated person,” but also

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85. *Id.*, 141 CONG. REC. at H13,703.

86. *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357, 371 (3d Cir. 1993) (“Nevertheless we can state as a general matter that, when an offering document’s forecasts, opinions or projections are accompanied by *meaningful cautionary statements*, the forward-looking statements will not form the basis for a securities fraud claim if those statements did not affect the ‘total mix’ of information the document provided investors. In other words, cautionary language, if sufficient, renders the alleged omissions or misrepresentations immaterial as a matter of law.” (emphasis added)).

87. *Id.* (“Of course, a vague or blanket (boilerplate) disclaimer which merely warns the reader that the investment has risks will ordinarily be inadequate to prevent misinformation. To suffice, the cautionary statements must be substantive and tailored to the specific future projections, estimates or opinions in the prospectus which the plaintiffs challenge.”).

acknowledged the general unavailability of the PSLRA safe harbor to issuers of municipal securities when they disclose forward-looking or trend information. Therefore, in its list of recommended reforms that would require Congressional legislation, the SEC proposed that Congress enact a public finance safe harbor that is similar to the PSLRA to “encourage municipal issuers to provide forward-looking information.”<sup>87.1</sup> The SEC’s proposed legislation would

[p]rovide a safe harbor from private liability for forward-looking or trend statements of repeat municipal issuers who are subject to and current in their ongoing disclosure obligations that satisfy certain conditions, including appropriate risk disclosure relating to such forward-looking statements, and, if projections are provided, disclosure of significant assumptions underlying such projections.<sup>87.2</sup>

**[D] SEC v. Greater Wenatchee Regional Events Center Public Facilities District**

The mishandling of projections or forward-looking statements can lead to a garden-variety case of fraud, regardless of any disclaimers. In 2013, the SEC brought an enforcement proceeding against the Greater Wenatchee Regional Events Center Public Facilities District (District), which was formed in 2006 under Washington State law by nine Washington cities and counties to finance, construct, and operate a multiuse arena and ice hockey rink (Regional Center).<sup>87.3</sup> Also named as respondents were Global Entertainment Corporation, a developer and manager of event facilities primarily in the southwest, and individuals associated with the development of the Regional Center. Global was retained as the developer and initial operator of the Regional Center. The Regional Center was to be located in the City of Wenatchee. The city was the leading promoter of the project among the cities and counties participating in the inter-local agreement, and the District, rather than hiring its own employees, entered into an agreement with the city to use city personnel to oversee the development.

The enforcement action related to materially false and misleading statements in an official statement for three-year bond anticipation notes (BANs) issued by the District in 2008. Prior to 2008, the District had entered into a loan agreement with a construction lender, which

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87.1. 2012 Report on the Municipal Securities Market, *supra* note 7.1, at 138.

87.2. *Id.* at 137–38.

87.3. *In re* Greater Wenatchee Regional Events Center Public Facilities District, SEC Cease-and-Desist Order (Nov. 5, 2013), [www.sec.gov/litigation/admin/2013/33-9471.pdf](http://www.sec.gov/litigation/admin/2013/33-9471.pdf).

the District expected to repay from the proceeds of long-term bonds. In 2006 and 2007, Global had made projections of revenues to be received by the Regional Center, but Global had little experience with financial projections or public finance. The Wenatchee city council retained an independent consultant to review Global's 2006 and 2007 projections, and in both years the independent consultant expressed doubts about the legitimacy of the projections. The District was unable to sell long-term bonds in 2008, and the construction lender was demanding lease payments that would require the District's immediate access to the capital markets. The District resorted to the sale of \$41.8 million of BANs as a temporary measure.

According to the independent consultant's first report prepared for the city in 2006, the scope of its work was "to prepare an impartial third party review of the reasonableness of [Global's] financial projections to ensure the financial pro-forma presented to the City is realistic and attainable." The independent consultant concluded there could be an operating deficit and that Global's projection of annual net operating income was possibly overstated by 16% to 25% in the first year. As a result of the recession, the Regional Center project was downsized, and Global made new projections. The independent consultant was again retained by the city, and again it saw issues with Global's new projections. In early 2008, Global became concerned that the sale of luxury and premium seats, naming rights, and advertising was not achieving its expected results, and Global itself reduced its financial projections. These projections were too low for underwriters to sell long-term bonds, and local political pressure was put on Global to make the projections more favorable. Global raised its projections of cash flow before taxes and debt service from \$370,000 to \$839,000 annually, and, when the sale of bonds was still not feasible, the new projections were included in the official statement for the BANs.

The official statement for the BANs also included the following language found to be false by the SEC:

No feasibility report on the [District] and Global's unaudited projected financial performance of the Regional Center has been prepared and the unaudited projected financial performance of the Regional Center has not been examined by any financial adviser or by any accounting or other firm in order to verify either the reasonableness of the assumptions used by the [District] and Global, the appropriateness of the preparation and presentation of the unaudited projected financial performance of the Regional Center or the conclusions contained in such unaudited projected financial performance of the Regional Center.<sup>87.4</sup>

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87.4. *Id.* at 8.

The Regional Center's financial results were worse than Global's most pessimistic projections. The Regional Center operated at a significant net operating loss, and, when bonds could not be issued to take out the BANs, the District defaulted on the repayment of the BANs. The SEC found that the official statement for the BANs was materially misleading because, contrary to the statement inserted in the official statement quoted above, the projected financial performance of the Regional Center had been examined twice by an independent consultant, and those reviews raised questions about the Regional Center's economic viability in two separate reports. The official statement thus omitted material facts about the independent consultant, as well as making misleading projections.

In addition to the projections being misleading, the SEC found the official statement misleading because it led investors to believe that, if the District could not issue bonds to take out the BANs, the city would use its credit to make the payment. In 2006, the city council had approved the execution of the inter-local agreement with the District pursuant to which the city agreed to provide financial support for all or a portion of the bonds to be issued by the District. The official statement for the BANs failed to state that the city's ability to meet this obligation was limited by the city's debt ceiling, which would not allow it to issue bonds in excess of \$19 million.

### **§ 8:3.5      *Drafting Risk Factors***

Paralleling the SEC's promotion of plain English and a clearly written section on management discussion and analysis (MD&A), which is to put the investor in the shoes of management, the SEC has shown an increased emphasis on the language employed in drafting risk factors. A risk factors section can highlight key issues for a potential investor to consider and focus attention on the concerns an investor would likely raise if the disclosure document were an interactive communication between the issuer and potential investors. The origins of risk factors sections were in S-1 registration statements, particularly for initial public offerings, annual reports for foreign private issuers, and private placement memoranda. In its 2004 proposal dealing with securities offering reform, the SEC proposed to extend risk factor disclosure in the Form 10-K and Form 10-Q reports.<sup>88</sup> The requirements for risk factor disclosure subsequently appeared in Item 503 of Regulation S-K for registered offerings. Rule 421(d) then required the risk factors section to be written in plain English.

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88.      Securities Act Release No. 8501 (Nov. 17, 2004).

Item 503, which does not apply to municipal securities exempt from registration, states that a risk factors section is to be included “where appropriate,” and that the purpose of the section is to discuss the most significant factors that make the offering speculative or risky. The following principles are contained in Item 503 for writing risk factors:

- The discussion is to be concise and organized logically.
- Do not present risks that could apply to any issuer or any offering.
- Explain how the risk affects the issuer or the securities being offered.
- Set forth each risk factor under a sub-caption that adequately describes the risk.
- The risk factor discussion must immediately follow the summary section.

Risk factors sections do not appear across the board in public finance. The purpose of including risk factors is to alert potential investors of risks specific to the issuer or its industry. If a state, county, or municipal corporation issues full faith and credit general obligation bonds, it is highly unlikely that there will be a risk factor section. Any risks should be fully apparent in the description of the economy and demographics. Likewise, an issue of water and sewer revenue bonds with mandatory connections, mandatory payment of fees along with the payment of property taxes, and the threat that water will be turned off if payments are not made, should not require a risk factors section. A different conclusion may be reached for a new construction project financing in which the source of repayment for the bonds is limited to the project being financed. In that case, it may be appropriate to have a risk factors section with sub-captions for construction risks, start-up risks, and operating risks. The headings for construction, startup, and operating risks should each have sub-captions that clearly identify the type of risk—for example, permit risk and contractor risk under construction risks.<sup>89</sup>

Public finance includes many issues for nonprofit corporations and similar entities that are not subject to the registered offering rules, but have corporate characteristics that suggest their issuers should consider a risk factors discussion. A nonprofit hospital, for example, may choose to follow the traditional corporate categories: (1) industry risks,

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89. National Federation of Municipal Analysts, White Paper on Project Finance Risk Assessment and Disclosure (Aug. 2006), available at [www.nfma.org](http://www.nfma.org).

(2) company risks, and (3) investment risks.<sup>90</sup> Industry risks are risks faced by nonprofit hospitals generally, such as third-party payor risks. Company risks (that is, risks faced by the particular hospital) might include a sub-caption on competition, but it is important not to draft the risk so generally that it would apply to every corporation in a competitive economy or even every hospital. The competition risk under the company heading should relate to the particular competitive health care facilities in the hospital's service area.

Risk factors should be drafted consistently with other sections of the official statement. For example, an MD&A section describes known facts or conditions that are expected to have a significant effect on the financial position of the issuer. The risk factors section can then discuss the risks to the investor implicit in those facts or conditions. Each risk factor should be written concisely and in a style that is easily readable, and should be carefully tailored to the specific risk being described. Concrete examples are appropriate. The first sentence of each risk factor should convey the risk being described and, within the major sub-captions, there should be an effort to list risks in their order of importance.

In its 2012 Report on the Municipal Securities Market, the SEC cited a number of studies on the timeliness of annual financial information. A study by the National Association of State Comptrollers showed a wide variety of CAFR completion times among states. The average time for all fifty states was 205 days for 2006 through 2009, and 188 days for 2010. Illinois took 237 days in 2006 and 376 days in 2008; New Mexico was 731 days in 2006 and 215 days in 2008. A 2011 Merritt Report analyzed 25,500 audits for 6,600 different municipal issuers over a four-year period, and found that the average time for the audit report to be completed after the close of the fiscal year was nearly five months.<sup>90.1</sup>

## **§ 8:4 Financial Statement Disclosure Issues**

### **§ 8:4.1 Disclosure Problems Caused by Use of Aged Financial Statements**

In an offering of securities subject to the registration requirements of the 1933 Act, the SEC tightly controls the form, the content, the timing, and the length of the period before the financial statements are rendered "stale" and not acceptable for a registration statement.

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90. Robert B. Robbins & Philip L. Rothenberg, *Securities Disclosure: Writing Effective Risk Factor Disclosure in Offering Documents and Exchange Act Reports*, 19 INSIGHTS No. 5 (May 2005).

90.1. 2012 Report on the Municipal Securities Market, *supra* note 7.1, at 76–77.

Rule 3-12 of Regulation S-X, which is the body of rules on the form and content of corporate financial statements, provides that if financial statements have aged more than a specified number of days (usually 134 days) before the expected effective date of a registration statement, the issuer will be required to prepare interim unaudited financial statements.

The SEC in 2007 delivered a white paper to Congress recommending legislation mandating that municipal issuers use generally accepted accounting principles promulgated by GASB.<sup>91</sup> The SEC had determined that 20,000 issuers of municipal securities used a variety of accounting methods that did not conform to GASB standards.<sup>92</sup> GASB has itself explained that while private company accounting is to shed light on profits, government accounting must take into consideration the information required by three different constituencies: (1) the public as users of government services, (2) other government agencies with oversight responsibilities, and (3) investors and creditors. State and local accounting procedures are subject to state law, and lawmakers may not put the highest priority on the interests of investors and creditors.<sup>93</sup>

The SEC's white paper goes beyond requesting legislation that would require governments to conform financial statements to GAAP standards promulgated by GASB. The SEC also requests that Congress give the SEC oversight authority over GASB comparable to its authority with respect to FASB and the Public Company Accounting Oversight Board, provided by section 108 of Sarbanes-Oxley. The white paper argues:

The GASB has made progress in recent years in improving financial reporting standards, but the GASB needs greater support to better serve users of financial reports of governmental entities. Greater support for the GASB could be provided in several ways, including legislation allowing the Commission to mandate compliance with GASB standards, granting the Commission clear authority, similar to that in Section 108 of the Sarbanes-Oxley Act, to designate GASB standards as "generally accepted" for municipal issuers (provided that the Commission could make

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91. SEC, *Disclosure and Accounting Practices in the Municipal Securities Market*, accompanied by transmittal letter of SEC Chairman Cox (July 26, 2007). See also Statement of SEC Chairman Cox before the Banking, Housing, and Urban Affairs Committee, U.S. Senate (July 31, 2007).

92. *Id.*

93. GASB, Concept Statement No. 1: Objectives of Financial Reporting, available at [www.gasb.org](http://www.gasb.org).

the necessary findings), with the attendant authority to oversee the GASB, and providing funding to strengthen the GASB's independence.

Section 108 of Sarbanes-Oxley is built into section 19 of the 1933 Act. A reading of section 19 shows that comparable powers with respect to state and local government accounting would give the SEC substantial authority to adopt rules that would address the disclosure function of financial statements, probably including requirements for interim financial statements if the audited financial statements are unreasonably "stale" at the time an official statement is delivered. Without such rules, issuers must currently review their financial statements at the time they sell securities solely by reference to the antifraud rules as described below.

In October 1996, the SEC accepted the offer of Maricopa County, Arizona to settle a cease-and-desist proceeding.<sup>94</sup> The Maricopa Order contained findings that Maricopa County issued \$25.575 million in general obligation project bonds and \$22.25 million in general obligation refunding bonds, and that Maricopa County violated section 17(a) of the 1933 Act, section 10(b) of the 1934 Act and Rule 10b-5 thereunder in connection with the offer and sale of both issues. The project bonds and the refunding bonds were issued between July 26, 1993, and August 10, 1993, and the official statements contained financial statements for the year ended June 30, 1992. The SEC found that between the date of the financial statements in mid-1992 and the date of the official statements in mid-1993, Maricopa County's financial condition had materially worsened, operating cash flow had materially declined, and deficits in certain fund balances had materially increased, and the SEC found that the official statements failed to disclose these adverse changes.

The SEC did not use its drafting of the Maricopa Order to conclude that one-year-old financial statements or unaudited financial statements may not be included in an official statement. Drafters of official statements are left to make judgments of materiality without any imposition of line item requirements embedded in a cease-and-desist order. The findings are a straightforward application of the antifraud rules, and the implication of the Maricopa Order is that if aged financial statements are used in an official statement in circumstances in which they do not accurately portray the financial condition at the date of the official statement, the official statement should contain

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94. Exchange Act Release No. 37,779 (Oct. 3, 1996) (Maricopa Order).



sufficient updating information to assure that the disclosure as a whole is not misleading.

The litigated enforcement proceedings<sup>95</sup> against the City of Miami reiterated the principle of the Maricopa County settlement that the official statement speaks as of its date and not as of the date of the fiscal year-end financial statements or the date of the auditor's letter that is included in the official statement. The issuer must evaluate the aged financial statements as though they speak on the date of the official statement, and make whatever material disclosures are necessary to prevent any misleading effect there may be as of the date of the official statement. The Miami proceedings have the precedential benefit of litigation before an administrative law judge, and add several principles to the Maricopa County settlement in connection with aged financial statements.

The City of Miami's 1994 fiscal year ended September 30, 1994, the date of the financial statements at issue. The auditor's field work continued until the date of the auditor's report, February 28, 1995. On February 28, 1995, the city released its 1994 Comprehensive Annual Financial Report (1994 CAFR). The 1994 CAFR, which was disseminated to the marketplace, included the 1994 financial statements and a transmittal letter to the mayor and the city commissioners from the city manager and the finance director. The city later sold three issues of bonds in June, August, and December, 1995. The three bond issues were rated AAA because they were secured by bond insurance.

The following events, among others, led to the SEC's enforcement proceedings charging that the 1994 CAFR, and each of the official statements for the three 1995 bond offerings, contained materially misleading statements and omissions:

- In September 1994, the city commission approved the 1995 fiscal year budget, which was required to be balanced under Florida law, but was balanced, in part, by including certain federal grants that city officials knew would not be received in fiscal year 1995.
- In October 1994, the city financial advisors warned city officials by letter that the city's credit ratings were likely to be downgraded because of inadequate reserves and reliance on nonrecurring revenues and asset sales.
- In December 1994 and January 1995, the auditor, who was continuing the field work, warned the city of a \$35 to

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95. *In re* City of Miami, Florida, Cesar Odio and Manohar Surana, Initial Decision Release No. 185 (June 22, 2001), *aff'd*, Securities Act Release No. 8213, Admin. Proc. File No. 3-10022 (Mar. 21, 2003).

\$40 million deficit in fiscal year 1995 and of the likelihood the city would run out of cash in May 1995.

- The administrative law judge found that the city was in a crisis situation as of January 1995.
- The 1994 CAFR, released February 28, 1995, contained a footnote number 9 to the 1994 financial statements disclosing that in February 1995 the city initiated a review process to “right size” its operations to reduce the 1995 fiscal year budget by \$30 million.
- The 1994 CAFR transmittal letter stated: “To the best of our knowledge and belief, the enclosed data is accurate in all material respects and is reported in a manner designed to present fairly the financial position and results of operations of the various funds and account groups of the City. All disclosures necessary to enable the reader to gain an understanding of the City’s financial activities have been included.”
- Each of the official statements incorporated the 1994 audited financial statements, including footnote 9, and a certificate of the city manager stating that the official statement was free of misstatements and omissions of material facts and that there had been no material adverse change in Miami’s financial condition since September 30, 1994.

Prior to its release of a clean audit opinion on February 28, 1995, the auditor had considered qualifying its opinion with respect to whether Miami would remain a going concern. The auditor had to consider events occurring between the end of the fiscal year and the audit date as part of its subsequent-events work. The administrative law judge concluded that a clean or unqualified audit opinion indicated, among other things, that the auditors believed the city would be able to continue as a going concern and pay its bills for a year from the date of the financial statements. City officials convinced the auditors not to write a going concern qualification because the city would be able to close its deficit with expense reductions and the issuance of bonds. In fact, proceeds of the June 1995 bond issue to finance sewer improvements were diverted to address the revenue deficiency in the operating fund.

The administrative law judge and the SEC found that the 1994 CAFR was materially misleading as of its date because it did not discuss the city’s cash flow crisis. Note 9, rather than addressing the crisis, gave the false impression that “operation right-size” would replenish the deficits and that it was a beneficial program when, in reality, it was an ineffective program that could not solve the deficit

problem. The city tried to argue that the 1994 CAFR could not be misleading because it was released on February 28, 1995, the date the city received a clean audit opinion. The administrative law judge held that any determination of the adequacy of the 1994 financial statements under generally accepted accounting and auditing standards was not determinative of the city's disclosure obligations under the federal securities laws. An "audit's compliance with GAAP and GAAS does not foreclose a finding that the same documents could be misleading to investors."<sup>96</sup>

The inadequacy of the disclosure only became worse as the same audited 1994 financial statements were used later in 1995 in connection with the three bond issues. The administrative law judge found that investors were not informed of the pertinent conditions and events giving rise to the cash flow difficulties, the possible effect of those conditions, and management's evaluation of those conditions. The auditor's clean opinion did not relieve the city from its disclosure responsibility. In the case of the bond issues, the auditors also consented to the use of the audit report in the official statements. The consent letter implied that certain additional procedures were undertaken by the auditor, as described later in this chapter, but a consent letter does not relieve the issuer from primary responsibility for the disclosure of material information related to its financial condition.

In 2013, the SEC filed a civil complaint in the U.S. District Court for the Southern District of Florida charging that the City of Miami made false and misleading statements about its financial condition in three 2009 bond offering documents.<sup>96.1</sup> In its request for injunctive relief, the SEC charged that, in addition to the 2009 fraudulent misrepresentations, the city was in violation of the 2003 cease-and-desist order, and asked the court to order the city to comply with the 2003 cease-and-desist order. The complaint stated: "In March 2003, the Commission instituted a cease-and-desist order against the City for violations of the antifraud provisions of the federal securities laws in connection with bonds the City issued in 1995. The City has gone on to violate these same provisions again—this time in connection with three bonds the City issued in 2009."<sup>96.2</sup> Obtaining a civil injunction to enforce a cease-and-desist order provides the SEC with additional remedies.<sup>96.3</sup> The 2013 Miami case was the SEC's first

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96. *Id.* (citing SEC v. Caserta, 75 F. Supp. 2d 79, 92 & n.2 (E.D.N.Y. 1999)).  
96.1. SEC v. City of Miami, Florida, and Michael Boudreaux, Litigation Rel. No. 22,753 (July 19, 2013).  
96.2. Complaint, SEC v. City of Miami, Florida, and Michael Boudreaux, Case 1:13-civ-22600, Doc. 1 (July 19, 2013).  
96.3. *See* section 15:8.3.

injunctive action against a municipality already under an existing cease-and-desist order.

### **§ 8:4.2 Quantitative Versus Qualitative Materiality: SAB 99**

Lawyers and accountants evaluating the materiality of facts have traditionally applied a quantitative standard by which a misstatement or omission that did not result in an excess of a 5% mistake in the financial statements was not viewed as material.<sup>97</sup> The 5% rule of thumb was considered a useful standard that allowed clear determinations of materiality. The SEC, however, became increasingly concerned with a small quantitative error that might have a significant “qualitative” impact. For example, if a 2% increase in a company’s net income were to make the difference between meeting or not meeting street expectations of quarterly earnings, an intentional change in the numbers could have a major impact on market reaction to the announcement.

As discussed above, Rule 10b-5 materiality is to be considered “in light of the circumstances,” and the staff of the SEC has concluded that the “surrounding circumstances” include such qualitative variables as whether a company has met street expectations on earnings. Accordingly, in 1999 the staff released an accounting bulletin to provide guidance in applying materiality thresholds to the preparation of financial statements filed with the SEC.<sup>98</sup> SAB 99 applies to financial statements filed with the SEC and therefore is not directly applicable to public finance disclosure documents, but SAB 99 should be reviewed for its statement of the staff’s interpretation of quantitative and qualitative materiality. Additionally, qualitative disclosure has been applied by the courts in antifraud cases where the quantitative effect has been minimal. The staff summarized its view of the importance of qualitative factors in SAB 99 as follows:

The use of a percentage as a numerical threshold, such as 5%, may provide the basis for a preliminary assumption that—without considering all relevant circumstances—a deviation of less than the specified percentage with respect to a particular item on the registrant’s financial statements is unlikely to be material. The staff has no objection to such a “rule of thumb” as an initial step in assessing materiality. But quantifying, in percentage terms, the magnitude of a misstatement is only the beginning of an analysis

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97. For a historical review of materiality standards in SEC filings, see J.M. Fedders, *Qualitative Materiality: The Birth, Struggles, and Demise of an Unworkable Standard*, 48 CATH. U. L. REV. 41 (1998).

98. Staff Accounting Bulletin No. 99 (Aug. 12, 1999) (SAB 99).

of materiality; it cannot appropriately be used as a substitute for a full analysis of all relevant considerations . . . . Under the governing principles, an assessment of materiality requires that one views the facts in the context of the “surrounding circumstances,” as the accounting literature puts it, or the “total mix” of information, in the words of the Supreme Court. In the context of a misstatement of a financial statement item, while the “total mix” includes the size in numerical or percentage terms of the misstatement, it also includes the factual context in which the user of financial statements would view the financial statement item. The shorthand in the accounting and auditing literature for this analysis is that financial management and the auditor must consider both “quantitative” and “qualitative” factors in assessing an item’s materiality. Court decisions, Commission rules and enforcement actions, and accounting and auditing literature have all considered “qualitative” factors in various contexts.<sup>99</sup>

The SEC enumerated the following considerations that might render a quantitatively small misstatement qualitatively material:

- whether the misstatement arises from an item capable of precise measurement or whether it arises from an estimate and, if so, the degree of imprecision inherent in the estimate
- whether the misstatement masks a change in earnings or other trends
- whether the misstatement hides a failure to meet analysts’ consensus expectations for the enterprise
- whether the misstatement changes a loss into income or vice versa
- whether the misstatement concerns a segment or other portion of the registrant’s business that has been identified as playing a significant role in the registrant’s operations or profitability
- whether the misstatement affects the registrant’s compliance with regulatory requirements
- whether the misstatement affects the registrant’s compliance with loan covenants or other contractual requirements
- whether the misstatement has the effect of increasing management’s compensation—for example, by satisfying requirements for the award of bonuses or other forms of incentive compensation

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99. *Id.*

- whether the misstatement involves concealment of an unlawful transaction.<sup>100</sup>

The release of SAB 99 in August 1999 followed shortly after the SEC announced settlement of an enforcement action against W.R. Grace & Co. and two of its auditors in June 1999.<sup>101</sup> The SEC charged Grace with accounting fraud, alleging that Grace falsely reported the results of operations for itself and its Health Care Group from 1991 through 1995 and that Grace deferred reporting income earned by a subsidiary to “smooth” the earnings of the Health Care Group. The means used for the deferral included increasing existing reserves or creating new reserves in contravention of generally accepted accounting principles, and applying the reserves to manipulate the earnings of the Health Care Group. The purpose, according to the complaint, was to bring the Health Care Group’s earnings in line with Grace’s earnings targets for the Health Care Group.

The year following SAB 99, the Second Circuit overruled a district court decision (decided shortly before SAB 99) that a 1.7% misstatement in the amount of revenues was immaterial.<sup>102</sup> The Second Circuit concluded that the district court was in error, and reasoned that materiality determinations depend on “all relevant circumstances and not on numerical, bright line formulas.” The Second Circuit recognized that SAB 99 is not the law, but indicated it is consistent with Supreme Court cases looking at the “total mix” of information.

Similarly, a district court ruled that misleading statements regarding the revocability of contracts (a qualitative variable) may be material despite the contracts’ low value.<sup>103</sup> Plaintiffs alleged that Unisys knowingly made misleading statements about long-term contracts with British Telecommunications and the U.S. government. Unisys argued that each contract represented less than .6% of the company’s annual revenues, but the court rejected the idea that materiality determinations could be based on quantitative formulas and thresholds. Materiality must be considered on the basis of whether the information may significantly alter the “total mix” of information available to the investor.

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100. *Id.*

101. *In re* W.R. Grace & Co., File No. 3-9926 (June 30, 1999); *In re* Thomas J. Scanlon, CPA, File No. 3-9938 (June 30, 1999); *In re* Eugene Vaughan, CPA, File No. 3-9927 (June 30, 1999); *SEC v. W.R. Grace & Co.*, No. 98-8942 CIV Hurley (S.D. Fla., filed Dec. 22, 1998).

102. *Ganino v. Citizens Utils.*, Fed. Sec. L. Rep. (CCH) ¶ 91,210 (2d Cir. 2000).

103. *In re* Unisys Corp. Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 91,218 (E.D. Pa. 2000).

### § 8:4.3 Pro Forma Statements

A “pro forma” presentation of financial information generally refers to a presentation of earnings and results of operations on the basis of methodologies other than generally accepted accounting principles. In public finance, in order to provide a summary in accessible form, pro forma information may be brought forward to the front part of the official statement, based on the issuer’s financial statements contained in an appendix. The SEC recognizes that pro forma statements may serve a useful purpose, but has cautioned that such presentations may be misleading if they obscure GAAP results.<sup>104</sup> In its statement, the SEC made the following arguments:

- Because pro forma financial information involves “selective editing” of GAAP results, “companies should be particularly mindful of their obligation not to mislead investors when using this information.”
- The basis of any non-GAAP presentation should be clearly disclosed. Thus, if certain results are excluded, such as “unusual or nonrecurring transactions,” the presentation “should describe the particular transactions and the kind of transactions that are omitted and apply the methodology described when presenting purportedly comparable information about other periods.”
- Attention must be paid to any material information that is omitted from a presentation. If pro forma results omit or obscure a result that would be material under GAAP (for example, by noting a pro forma profit in the case of a GAAP loss), “clear and comprehensible explanations of the nature and size of the omissions” are likely to be needed to avoid misleading investors.
- A non-GAAP presentation in an earnings release should generally be accompanied by a statement “in plain English” explaining how the disclosures “have deviated from GAAP and the amounts of each of those deviations.”<sup>105</sup>

The SEC’s cautionary statement was followed within six weeks by a cease-and-desist order against Trump Hotels & Casino Resorts, Inc.<sup>106</sup> The SEC found that a press release had disclosed earnings in a manner that distorted generally accepted accounting principles. The press

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104. Exchange Act Release No. 45,124 (Dec. 4, 2001).

105. *Id.*

106. *In re* Trump Hotels & Casino Resorts, Inc., SEC Cease-and-Desist Order, Exchange Act Release No. 45,287 (Jan. 16, 2002).

release stated that net income and earnings-per-share pro forma figures excluded an \$81 million one-time charge. The press release, however, failed to disclose that the pro forma figures included a one-time gain of \$17 million. The effect of the inclusion of the \$17 million one-time gain resulted in the net income and earnings-per-share figures meeting analyst expectations, which would not have been the case if the \$17 million were excluded. The SEC concluded that the press release was misleading and in violation of Rule 10b-5 because it implied that all one-time items were excluded.

#### **§ 8:4.4 Management Discussion and Analysis: GASB 34**

Companies subject to the reporting requirements of the 1934 Act are required to include in their quarterly and annual reports a management discussion and analysis (MD&A) of the financial statements in accordance with the requirements of Item 303 of Regulation S-K. The SEC has emphasized that the purpose of MD&A is to provide information on the financial condition of the company “through the eyes of management.”<sup>107</sup>

One main theme in the development of Item 303 has been to focus on “trends.” For example, among the requirements for discussions of liquidity, capital resources and results of operation, the reporting company is to

- identify any known trends or any known demands, commitments, events or uncertainties that are reasonably likely to result in liquidity<sup>108</sup> increasing or decreasing in a material way;
- describe material commitments for capital expenditures and any known trends in capital resources; and
- describe any unusual or infrequent events, transactions or significant economic changes that materially affected the amount of reported income and known trends or uncertainties that have had or are expected to have a material impact on net sales or revenues.

Item 303 uses the term “trends” distinctly from general references in securities law to “projections,” by stressing that MD&A requires only disclosure of “currently known trends, events and uncertainties that are reasonably expected to have material effects.”<sup>109</sup>

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107. See, e.g., *In re* Presses, Inc., Exchange Act Release No. 39,472 (Dec. 22, 1997); *In re* Sony Corp., Exchange Act Release No. 40,305 (Aug. 5, 1998).

108. Item 303 defines liquidity as the ability to generate adequate cash to meet the needs for cash.

109. Exchange Act Release No. 6711 (Apr. 24, 1987).



Projections are described by the SEC to involve the anticipation of “a future trend or event or anticipating a less predictable impact of a known event, trend or uncertainty.”<sup>110</sup>

The application of the SEC’s emphasis on “known” trends or uncertainties may be illustrated by its 1994 enforcement action against America West Airlines, Inc.<sup>111</sup> America West had experienced severe losses due to decreased passenger traffic levels and increased fuel costs, resulting in a severe weakening of its liquidity. The liquidity problems resulted in covenant defaults with lenders. Management initiated negotiations with lenders for long-term financing and conducted a half-price ticket sale to increase passenger traffic. The SEC found that it was not reasonably likely that America West would be able to restore its weakened liquidity, and therefore it was required to include a discussion of the known material uncertainty related to liquidity in MD&A.

States and political subdivisions are generally not subject to the 1934 Act reporting requirements and therefore are not subject to Item 303 of Regulation S-K. The fifty states and their political subdivisions, including special districts, public authorities, and public hospitals and universities, are expected to prepare their financial statements in accordance with standards established by the Government Accounting Standards Board (GASB). GASB was organized in 1984 by the Financial Accounting Foundation (FAF) to provide standards of financial accounting and reporting for states and political subdivisions. In 1973, FAF organized the Financial Accounting Standards Board (FASB), which has established generally accepted accounting principles (GAAP) for companies in the private sector. GASB was to establish GAAP for states and political subdivisions.<sup>112</sup>

In June 1999, GASB released its Statement No. 34 entitled “Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments.”<sup>113</sup> GASB 34 provides that states and political subdivisions that prepare their annual financial reports in conformity with GAAP are to include MD&A as required supplementary

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110. *Id.*

111. *In re* Am. W. Airlines, Inc., SEC Cease-and-Desist Order, Exchange Act Release No. 34,047 (May 12, 1994).

112. States and political subdivisions that prepare a Comprehensive Annual Financial Report (CAFR) add introductory material and schedules of financial, economic, and demographic information in addition to the basic financial statements.

113. GASB, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*, Statement No. 34 (June 1999) [hereinafter GASB 34].

information immediately preceding the basic financial statements. Basic financial statements are (1) the government-wide financial statements, (2) the fund financial statements, and (3) the notes to the financial statements. Government-wide financial statements display information about the reporting government as a whole, with separate columns for government activities<sup>114</sup> and business-type activities, if applicable.<sup>115</sup> The reporting government may be a limited purpose district, authority, or other public corporation, as well as general purpose governments such as states and cities. The basic financial statements are the same, and the MD&A requirement applies. The fund financial statements, which have traditionally characterized the accounting of states and political subdivisions, provide a more detailed view of funds created to track a particular part of the government's activities.<sup>116</sup>

The effect of states and political subdivisions having both government-wide and fund accounting is to expand the purposes of MD&A under GASB 34 in comparison with MD&A under Item 303 of Regulation S-K. GASB 34 requires a discussion of the relationship of the statements to each other and the significant differences in the information they provide. "This discussion should include analyses that assist readers in understanding why measurements and results reported in fund financial statements either reinforce information in government-wide statements or provide additional information."<sup>117</sup> Similarly, GASB 34 requires an analysis in the MD&A of fund balances and changes in fund balances.<sup>118</sup>

MD&A pursuant to GASB 34 should include condensed financial information from the government-wide financial statements comparing the current to the prior year. GASB 34 specifies fourteen elements that should be discussed.<sup>119</sup> In addition, MD&A is to provide an analysis of the government's overall financial position and results of operation:

The analysis should address both governmental and business-type activities as reported in the government-wide financial statements and should include *reasons* for significant changes from the prior

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114. Governmental activities are activities generally financed with taxes and unrestricted intergovernmental aid. Dean M. Mead, *An Analysts Guide to Government Financial Statements*, GASB User Guide Series (2001) at F-7.

115. Business-type activities are activities financed with fees charged for goods and services. *Id.* at F-2.

116. There are numerous reasons for states and political subdivisions to create separate funds for accounting purposes, including state law requirements and the tracking of revenues for specific bond resolutions or trust indentures.

117. GASB 34, ¶ 11.

118. *Id.*

119. *Id.*

year, not simply the amounts or percentages of change. In addition, important economic factors, such as changes in the tax or employment bases, that significantly affected operating results for the year should be discussed.<sup>120</sup>

A significant feature of many states and political subdivisions is the existence of budgets. GASB 34 requires discussion of the difference between original and final budgets and “any currently known reasons for those variations that are expected to have a significant effect on future services or liquidity.”<sup>121</sup> Governments also may use modified accounting methods for infrastructure, and these modifications are to be discussed, as well as the assessed condition of, and significant changes in, the infrastructure. Significant capital asset and long-term debt activity are to be discussed, as well as commitments for capital expenditure, changes in credit ratings and debt limitations that may affect financings, and their implications for planned facilities and services.

GASB 34 does not use the phrase “currently known trends and uncertainties,” which is prominent in Item 303 of Regulation S-K. However, GASB 34 does require the following:

A description of currently known facts, decisions, or conditions that are expected to have a significant effect on financial position (net assets) or results of operations (revenues, expenses, and other changes in net assets).<sup>122</sup>

For purposes of MD&A, the phrase “currently known facts” is defined as information that management is aware of as of the date of the auditor’s report. Illustrations include tax law changes that have been made but will first impact the following fiscal year, new labor contracts, or a final decision in a lawsuit that will affect expenses in following years.<sup>123</sup>

### **§ 8:4.5 Auditor Consents and Related Disclosure**

There is no SEC requirement for auditors of state and political subdivision financial statements to participate in, or become associated with, the preparation of an official statement.<sup>124</sup> An auditor can, however, agree to participate in drafting financial information to be

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120. *Id.*

121. *Id.*

122. *Id.*

123. Mead, *supra* note 114, at 77.

124. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, AUDIT AND ACCOUNTING GUIDE, STATE AND LOCAL GOVERNMENTS § 16.06.

included in the official statement and, as explained in chapter 14, be treated as a primary violator in respect of any misleading information within the orbit of the auditor's participation. In the SEC's complaint and settled action against San Diego's auditor,<sup>125</sup> the SEC took the position that the auditor, Calderon, Jaham & Osborn, and the engagement partner for San Diego, Thomas Saiz, were primary violators because Saiz drafted the footnotes in the financial statements that the SEC alleged were materially false and misleading regarding the city's funding of its pension and retiree healthcare plans. The complaint alleged the following:

Defendants violated the antifraud provisions of the Securities Act and Exchange Act because:

- (a) their footnote disclosures to the financial statements, which were included in the City's offering documents, contained materially false and misleading statements regarding the City's funding of its pension and retiree health care obligations; and
- (b) their audit reports were false and misleading because the City's pension and retiree health care obligations were not presented in conformity with GAAP and Defendants' audits of those obligations were not performed in accordance with GAAS.<sup>126</sup>

Auditors can become involved with a financing in response to an underwriter's due diligence requests for a comfort letter or agreed-upon-procedures letter (as described in chapter 7), but liability is probably limited to a privity action by the underwriters or an enforcement proceeding by the SEC, and not an action by investors, because it is unlikely that investors can show reliance on these letters to the underwriters. The SEC is not required to show reliance. Auditors can become involved in the official statement if they manually sign the report included in the official statement, particularly if the signature is to a bring-down to the date of the official statement, or if the auditor is engaged to prepare a separate report for purposes of the official statement.<sup>127</sup>

The auditor can assume limited responsibilities by consenting to the inclusion of the audited financial statements and covering letter in

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125. SEC v. Saiz, Litigation Release No. 20,394 (Dec. 11, 2007).

126. SEC v. Thomas J. Saiz and Calderon, Jaham & Osborn, Complaint, Case No. 07 CV 2308 L JMA, para. 3.

127. GFOA, *Recommended Practice, Auditor Association with Financial Statements Included in Offering Statements or Posted on Websites* (2005 and 2006), available at [www.gfoa.org](http://www.gfoa.org).

the official statement. The attachment of the audited financial statements to the official statement, however, in itself does not imply that the auditor has expressly consented to their inclusion or that the auditor has undertaken any bring-down procedures from the date of the auditor's letter to the date of the official statement. States and political subdivisions consider themselves owners of the audited financial statements, entitled to include them in the official statement without the obligation to incur the expense of obtaining a consent from the auditors. This conclusion has been expressed clearly by the GFOA:

*Having paid for the independent audit, a government owns the audited financial statements and should feel free to use them in any appropriate manner.*

GFOA believes that state or local governments as a general rule, should be free to publish their audited financial statements (including the report of the independent auditor) as they see fit (e.g., incorporated into an offering statement, posted on the government's web site), *without having to obtain prior permission from the auditor*, provided that all of the following conditions have been met:

- The independent auditor's report accompanies the same complete set of financial statements for which an opinion was rendered;
- The financial statements are not used in a potentially misleading manner; and
- No material subsequent event has occurred that might render the financial statements potentially misleading.<sup>128</sup>

The third bullet point above is important because it recognizes the principle of the City of Miami enforcement proceeding<sup>129</sup> that if the audited financial statements, dated day 1, are included in the official statement, dated day 2, and there have been material negative changes in the financial position of the issuer between day 1 and day 2, the issuer has an obligation to update clearly the financial statements to prevent an inference that they speak as of day 2.

If the auditor consents to the inclusion of the audited financial statement in the official statement, the consent implies that the auditor has engaged in limited bring-down procedures between day 1 (the date of the auditor report) and day 2 (the date of the official statement). What those procedures are is not entirely clear. Generally

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128. *Id.*

129. *In re* City of Miami, Florida, SEC Cease-and-Desist Order, Securities Act Release No. 8213 (Mar. 21, 2003).

Accepted Auditing Standards (GAAS) requires that, as a condition to the consent, the auditor is to read the information in the official statement and determine whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the official statement.<sup>130</sup> The SEC's complaint against San Diego's auditor took the position that a consent implies a degree of due diligence:

GAAS additionally imposes certain requirements on auditors when they consent to their audit opinions being included in a securities offering document. Specifically, GAAS requires the auditor to read the information in the offering document and determine whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements. AICPA Audit & Accounting Guide, "Audits of State and Local Governments" § 16.07. Upon concluding that there is a material inconsistency, the auditor should determine whether the financial statements, the audit report, or both require revision. AICPA Codification of Auditing Standards, AU § 550.04. As alleged above, in 2003, upon learning of the substantial negative change in CERS's funding liability and the City's unfunded liability, Saiz failed to inquire into such matters or to determine whether the financial statements, audit report, or both required revision.<sup>131</sup>

The SEC's position on the importance of the auditor's consent to inclusion of the auditor's opinion and the audited financial statements was buttressed by a 2007 speech by then SEC Chairman Cox entitled "Integrity in the Municipal Market," in which he argued (without giving content to the meaning of auditor consents) as follows:

[S]ome municipal issuers include audit opinions and audited financial information in disclosure documents without obtaining the consent of the auditor. When that happens, you—the investor—need to know about it. That's because in order to give its consent, an auditor must perform certain procedures. And some of those procedures are designed to detect events since the date of its audit opinion that may have a material impact on the issuer's financial condition. If there is no auditor's consent, then it is almost certain that no such procedures were performed. And that means the financial statements the issuer is asking you to rely on aren't as reliable as you thought.

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130. GFOA, *Recommended Practice, Auditor Association with Financial Statements Included in Offering Statements or Posted on Websites* (2005 and 2006), available at [www.gfoa.org](http://www.gfoa.org).

131. SEC v. Thomas J. Saiz and Calderon, Jaham & Osborn, Complaint, Case No. 07 CV 2308 L JMA, para. 37.

Among other things, auditor consents serve as a double check on the issuer's representations about changes to its financial condition since the period covered by the audit. You will be comforted to know that in the corporate market, the auditor's consent has to be obtained before its audit opinion can be included in an offering document. I dare say that most individual investors in municipal securities have no idea that this isn't always the case in a municipal offering. At a minimum, shouldn't issuers who don't obtain auditor consents at least disclose that fact, and tell investors what it means?<sup>132</sup>

The practical lesson to be drawn by issuers of municipal securities is that at the end of the official statement, after "tax issues," in the vicinity of the "underwriting" disclosure and any expert opinion disclosure, there should be a clear statement that the auditor has not consented to inclusion of the audit opinion and audited financial statements if that is the case. Investors should not be expected to presume the auditors have undertaken any post-audit bring-down procedures if the auditors have not been requested to implicitly engage in those procedures. On the flip side, if the auditors have given their consent, it may be worthwhile to state that fact, but not suggest the implication of the consent.

#### **§ 8:4.6 Interim Financial Reports**

Waiting five months after the end of a fiscal year for audited financial statements means that there is a seventeen-month gap between the end-of-the-year financial information for the fiscal year two years previous and the audit of financial information for the immediately preceding fiscal year. The gap in annual information caused by delayed audits suggests that having periodic disclosure of interim financial information is particularly important to investors and analysts of municipal securities. The SEC in its 2012 Report on the Municipal Securities Market gave considerable attention (and implicit encouragement) to the voluntary disclosure of interim financial information immediately after its discussion of the studies showing the lengthy amount of time between the end of the fiscal year and the date on which the audited financial statements of state and local governments are released. Rule 15c2-12 does not require underwriters to impose an obligation on issuers and obligated persons to provide interim financial information, and thus industry groups have used their prestige to promote voluntary disclosure of interim financial information either

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132. Christopher Cox, Chairman, SEC, Speech in Los Angeles: Integrity in the Municipal Market (July 18, 2007).

on issuer websites or on the MSRB's EMMA, which allows posting of such voluntary information.

In 2013, the National Association of State Auditors, Comptrollers and Treasurers (NASACT) released its "Voluntary Interim Financial Reporting Best Practices for State Governments."<sup>132.1</sup> Shortly after, the National Federation of Municipal Analysts (NFMA) endorsed the NASACT Best Practices.<sup>132.2</sup> The NASACT Best Practices did not constitute a recommendation that states produce interim "financial statements." The items recommended were currently available unaudited financial data. For those issuers capable of providing them, ten items are recommended to improve interim disclosure, and should be made on a central web-based location that is available to investors and the public. The items listed by NASACT were:

1. TAX REVENUES

This report should include all major tax revenues collected during the period. The report should also include information on major changes to a state's tax base, if any [listing such changes]. Such a report could also show the amount of revenue collected relative to a state's benchmark or prior fiscal year collections.

2. BUDGET UPDATES

Most states produce intra-year updates to the governor, the legislature or taxpayers such as year-to-date, budget-to-actual showing major categories of revenues and expenditures for the general fund and major governmental and enterprise funds. . . .

3. CASH FLOW

A cash flow forecast or report detailing the available cash resources that provide liquidity to the state's operating funds should be provided. Such reports may include the current fiscal year as well as previous or forthcoming years.

4. DEBT OUTSTANDING

A report detailing the balances of debt outstanding for the state, including both long-term and short-term debt should be provided. The report should include changes to the

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132.1. National Association of State Auditors, Comptrollers and Treasurers, Voluntary Interim Financial Reporting: Best Practices for State Governments (Aug. 2013), [www.nasact.org/files/News\\_and\\_Publications/White\\_Papers\\_Reports/2013\\_08\\_Best\\_Practices\\_Continuing\\_Disclosure.pdf](http://www.nasact.org/files/News_and_Publications/White_Papers_Reports/2013_08_Best_Practices_Continuing_Disclosure.pdf) [hereinafter NASACT Best Practices].

132.2. Press Release, National Federation of Municipal Analysts, NFMA Board Endorses NASACT Best Practices on Interim Disclosure (Sept. 16, 2013).



amount of debt outstanding from the previous period. An updated annual debt service schedule is also recommended.

#### 5. ECONOMIC FORECASTS

States should provide investors with updated economic forecasts, if such forecasts are being produced by the state already. . . .

#### 6. PENSIONS AND OPEB

If annual actuarial reports on a state's pension liability and other post-employment benefits (OPEB) are released, they should be included in that period's interim disclosures. If legislative changes are enacted that may impact future valuations or liabilities, those should also be included.

#### 7. INTEREST RATE SWAPS AND BANK LIQUIDITY

Interim disclosure reports should include updates to a state's interest rate swap portfolio, including updates on mark-to-market valuations as of the end of the quarter, and list the credit ratings of its swap counterparties. Also included should be information regarding bank liquidity and credit facilities, including standby bond purchase agreements, lines of credit etc. . . .

#### 8. INVESTMENTS

A report detailing the state's investment holdings, including balances in investment pools, deposits or other vehicles should be included. Such a report should detail the liquidity and credit quality of the state's investment holdings, including weighted average maturity, duration, and level of collateral posting for non-insured deposits.

#### 9. DEBT MANAGEMENT POLICIES

If the state updates its debt management policies, those new policies should be included in the interim disclosure report for the period in which the updated policy became effective.

#### 10. EMMA FILINGS

A state should include any EMMA filings, voluntary or mandatory, that have been made in the most recent period . . . . A state may wish to direct an investor or interested party to the EMMA website where they can set up a MyEmma account which will allow notices to be pushed out to the individual.<sup>132.3</sup>

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132.3. NASACT Best Practices, *supra* note 132.1, at 3–4.

The NASACT Best Practices indicated that the first four items on the above list should be updated regularly, and the remainder should be updated as the information changes. The NASACT also recommended that each state should formulate appropriate disclaimer language and terms of use to be included with the voluntary disclosures.

The Government Finance Officers Association (GFOA) routinely publishes best practice guidelines. In a 2010 best practices report entitled “Understanding Your Continuing Disclosure Responsibilities,”<sup>132.4</sup> the GFOA reminded its constituents that “[n]othing prohibits issuers from providing periodic voluntary information to investors in addition to fulfilling the SEC Rule Rule 15c2-12-12 responsibilities.” Information governments may want to submit to EMMA and post on their websites “includes annual budgets, financial plans, financial materials sent to governing bodies for council or board meetings, monthly financial summaries, investment information, and economic and revenue forecasts.” Like the NASACT, the GFOA also referenced agreements entered into in connection with debt issuance, including letters of credit, interest rate swaps, investment agreements for the investment of bond proceeds, including reserve funds, and insurance sureties used to fund reserve fund requirements.

## § 8:5 Pension Funding Obligations

Before considering pension funding disclosure that is material to investors, it may be worthwhile to think about information on pension benefits and other postemployment benefits (OPEBs) from the perspective of the taxpayers who are paying for the current and deferred compensation of public employees. If there are defined benefit plans, taxpayers should be informed of (1) average salaries by categories of workers that comprise each separate pension plan (for example, for police, firefighters, teachers, and general service government employees),<sup>133</sup> and other forms of current compensation that are reflected in the paycheck, and (2) the value of postemployment benefits from pension plans, OPEBs, and other sources, such as federal Social Security benefits that are paid by the government employer, or the value of any exemption of postemployment benefits from state income taxes. When the information is provided in a comprehensive and readable format, taxpayers will be in a position to evaluate

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132.4. Government Finance Officers Association, *Understanding Your Continuing Disclosure Responsibilities* (Oct. 2010), [www.gfoa.org/understanding-your-continuing-disclosure-responsibilities](http://www.gfoa.org/understanding-your-continuing-disclosure-responsibilities).

133. These four categories of employees frequently have separate pension plans, and a taxpayer analysis of post-employment benefits would be by reference to the group. If the sponsor’s pension systems consist of other categories of employees, those categories would be relevant for the taxpayer’s analysis.

whether the government is spending too much or too little of taxpayer money for services being performed, and whether the government, as trustee, is prudently managing taxpayer obligations to active and inactive employees. However, in order for taxpayers to understand the aggregate cost of annual compensation, and the cost of the postemployment benefit package, it will be necessary for the government to provide information about the cost of postemployment benefits allocated to the current year and each future year the worker is employed.

Taxpayers should also be able to determine whether they are, in fact, paying the postemployment benefits while each employee is working and providing services. Most experts believe that good public policy should require each generation of taxpayers to pay the full cost of the services it receives, and an important purpose of government accounting is to match the cost of providing postemployment benefits to the time period the employee works for the government.<sup>134</sup> This policy is easily recognizable by participants in the public finance industry who evaluate state and local government debt for capital projects. Amortization of bonds issued to finance, for example, a courthouse should provide reasonably level debt service for the number of years that does not exceed the period of probable usefulness of the courthouse. Debt service is level because the benefits afforded by the courthouse are generally level throughout its useful life, and taxpayers should be able to add each year's debt service to the amount budgeted for operating and maintaining the courthouse if they are to evaluate the amount they are paying for the courthouse in the current year. If the courthouse is nearing the end of its useful life and must be torn down and replaced with a new courthouse, which is to be financed with a new issue of bonds, and debt service on the old bonds is continuing for ten years after debt service on the new bonds commences, current taxpayers will, in effect, be required to make overlapping payments for two courthouses because the prior generation was unwilling to pay for the services it received while the first courthouse was operational.

It is easy to see how the dissatisfaction of the second generation of taxpayers translates into the concerns of investors being asked to invest in bonds for the second courthouse when there remain unfunded debt liabilities on a demolished building that must be partially paid by the second generation of taxpayers. A series of questions will be obvious to investors, beginning with the extent of the unfunded liability and the way it will be paid, and continuing to a whole set of questions focused on the demographic information needed to

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134. A. MUNNELL, *STATE AND LOCAL PENSIONS: WHAT NOW?* 48 (2012).

evaluate whether the second generation will be able to afford to pay (or will remain to pay) “double” debt service for one courthouse, and whether the current government is likely to continue a policy of mismanagement. Pension liability differs from scheduled debt service on courthouse bonds in that, by definition, the government’s liability extends beyond the date that an employee’s useful economic life ends (the date of retirement or the date employment otherwise terminates and benefits have vested), and the extent of the liability (unlike a debt service schedule for fixed-rate bonds) is unknown. Material information for investors thus expands beyond the disclosure appropriate for a courthouse financing to include an explanation of the assumptions made by actuaries to determine future liabilities, policies for investment of assets, returns on investments, the discount rate for present value calculations to determine whether funding reasonably reflects the current normal cost, and whether there are unfunded liabilities. If there are unfunded liabilities for postemployment pension benefits or OPEBs, both the taxpayer and the investor should be given information on the likelihood that unfunded liabilities will be eliminated while the government employee is still working, or if future taxpayers will be required to pay for two employees when only one is providing service.

The existence of a government’s unfunded pension liability and the illustration of the courthouse bonds can realistically be brought together by consideration of pension obligation bonds. The unfunded pension liability is the gap between what has been promised to employees in plan benefits and the assets that are likely to be available to meet those promises. If the governmental unit is experiencing budget pressures, a common solution is to calculate the unfunded liability, and to issue pension obligation bonds in an amount such that, when invested, the return on investments will pay the unfunded liability. No contributions under the budget process will be necessary to amortize the unfunded liability because it will appear to be fully paid by the deposit of the bond proceeds into the plan asset trust accounts. Setting aside the risk arbitrage inherent in the financing technique, there is the same potential danger that exists with the courthouse bonds if the amortization of the pension obligation bonds extends beyond the actuarial date of retirement or termination. Assume the government sponsor takes advantage of the pension obligation bonds to further alleviate budget pressures. Capitalized interest on the bonds is used to pay the first year of debt service, and debt service on the bonds is back-loaded so that the government in the early years is paying considerably less for debt service on the bonds than it would have paid if it were properly amortizing the unfunded

pension liability. The pension obligation bonds are, therefore, structured to avoid the discipline of annual budgeting for pension liabilities because, in the early years of the pension obligation bonds, the government is not having to budget for either unfunded pension liabilities or level debt service on the bonds.

### **§ 8:5.1 Preliminary Considerations**

Information that is material to investors and securities analysts differs from information that is material to taxpayers. Taxpayers are interested to know whether the government is a prudent trustee of public money, the extent to which resources are devoted to specific services, and the costs of providing those services. Investors focus more on information that is relevant to the ongoing ability of the government issuer to generate resources to pay debt service on the municipal securities being issued, including the costs of activities that may compete for those resources.<sup>135</sup> The 2012 NABL publication outlining considerations in the preparation of pension funding disclosure (NABL Considerations) repeatedly emphasized that official statement disclosure should focus on information that is material to investors and analysts evaluating a credit, and not provide any more or any less information than is appropriate for the purpose.<sup>136</sup> Materiality of pension funding information will vary depending on the relative size of pension obligations to the overall budget. For example, a public water authority may have relatively few employees in relation to the large size of its revenue base, and pension obligations may be of little importance in the total mix of information. In addition, the water revenue bonds may be secured by a pledge of the revenues derived from customer payments of water charges, and pension funding may come from the general revenues of the governmental unit in which the water authority is located. On the other hand, a city that is faced with rapidly expanding service needs that require increasing numbers of employees, but that has a declining tax base, is likely to make considerable disclosure about the effect of incurring new pension obligations, in order to adequately address issues material to investors.

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135. GOVERNMENT ACCOUNTING STANDARDS BOARD, WHITE PAPER: WHY GOVERNMENTAL ACCOUNTING AND FINANCIAL REPORTING IS—AND SHOULD BE—DIFFERENT (Apr. 2013).

136. NATIONAL ASSOCIATION OF BOND LAWYERS, CONSIDERATIONS IN PREPARING DISCLOSURE IN OFFICIAL STATEMENTS REGARDING AN ISSUER'S PENSION FUNDING OBLIGATIONS (PUBLIC DEFINED BENEFIT PLANS) (May 15, 2012) [hereinafter NABL CONSIDERATIONS]. NABL Considerations was prepared with the support of a Pension Disclosure Task Force comprised of representatives of issuers, underwriters, analysts, institutional investors, accountants, actuaries, and other interested parties.

The GFOA recommends that issuers implement appropriate procedures when determining the level of information that needs to be disclosed about their pension funding obligations relative to their financial position, and suggests that the issuer, legal counsel, and others on the financing team should address the following questions:

1. Is the debt service on the proposed bond issue and the funding of the issuer's pension plan dependent on the same *specialty identified* revenue source or sources?
2. Is the present and future funding of the pension plan material in relation to the issuer's current and projected budgets?
3. Is the funding of pension obligations currently stressing the issuer's budget or "crowding out" other expenditures, or have the potential of doing so in the future?
4. Are there legal restrictions or requirements related to pension funding that reasonably might be considered placing pension funding senior to debt service payments?
5. Are there known and determinable trends or issues related to pension funding that may be considered material to investors?<sup>137</sup>

The GFOA adds that if the answers to the above questions suggest that there could be an adverse impact on the ability to pay debt service, more extensive disclosure may be required, and NABL Considerations should be consulted. The disclosure suggestions in this section are likewise not necessary for many official statements, but may be useful if the facts and circumstances warrant additional disclosure on a specific topic covered below.

NABL Considerations also emphasizes that redundancy of disclosure is unnecessary. A government issuer that reports in accordance with GASB standards, has audited financial statements with comprehensive and clearly written pension plan notes, and provides GASB's required supplementary information (RSI) related to pension plans may be able, in the front part of the official statement, to reference the notes (or other reports, such as an actuary's report) for a considerable part of the disclosure. Some overlapping of information will be necessary for clarity, but the front part should probably focus more on an analysis of information, like MD&A, to respond to anticipated

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137. GFOA, Best Practice: Including Disclosure in Official Statements Related to Pension Funding Obligations (2012).

questions based on the reports. The one note to the financial statements covering pension obligations can run to six or seven pages of readable material information if GASB standards are applied, and GASB's additional RSI will cover several more pages that provide valuable information on the progress of plan funding. The description below of information that is material to investors is not intended to imply that extensive language needs to be drafted for the front part of the official statement. If material information in the financial statements or other reports is successfully referenced, the discussion in the front part of the official statement is likely to be very brief. Before drafting extensive disclosure in the front part of the official statement, the drafter should assemble and consider the extent to which disclosure can be made by reference, or links, to other documents, such as:

- The issuer's Comprehensive Annual Financial Report (CAFR);
- The issuer's and the pension plan's financial statements, notes, and RSI prepared in accordance with GASB standards;
- The issuer's publicly available adopted budget;
- Relevant statutes;
- The actuarial reports for the plan;
- Experience studies prepared at the request of the pension system;
- Pension plan written investment policies and asset allocation plans;
- Asset/liability modeling studies;
- Information on the sponsor's or system's website about plan benefits; and
- Other reports prepared internally or by consultants that are publicly available and that provide important information.<sup>138</sup>

### **§ 8:5.2      *The Funded Ratio: A Disclosure Snapshot of Pension Plan Financial Health***

A good portion of the information that is material to pension funding disclosure will fall into place if the drafter of the disclosure understands the basic concepts related to the funded ratio. The funded ratio is an analytic tool that is important to both taxpayers and investors. GASB Statement No. 25 and GASB Statement No. 27 define the funded ratio as the actuarial value of assets expressed as a

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138.      *See id.*; NABL CONSIDERATIONS, *supra* note 136.

percentage of the actuarial accrued liability (assets divided by liabilities).<sup>139</sup> Assets include cash, investments, and other property belonging to the pension plan. The valuation was actuarial because GASB allowed the value of assets to be smoothed over several years to reduce annual return volatility. Under the 2012 guidance, which is discussed below, assets are marked to market. Accrued liability is the portion of the present value of pension plan benefits and expenses that is not provided for by future normal contributions by government employers or employees. Plan benefits and expenses are determined by actuarial demographic and economic assumptions, and the present value calculation requires an assumed discount rate. Actuaries have traditionally computed liabilities by discounting future benefit payments using a discount rate based on the expected rate of return on the pension system's assets.<sup>140</sup> The 2012 guidance also modifies the discount rate for calculating the present value of future liabilities.

A rough analogy may be useful to understand the funded ratio. Assume an issuer has long-term fixed-rate term bonds outstanding that are to be paid at maturity, as to principal, by deposits of sinking fund installments into a sinking fund. The amount of the required sinking fund installments necessary in each year over a ten-year period is calculated on the assumption that assets accumulated in the sinking fund will be invested at an 8% return. That is, the investment of current assets in the sinking fund will pay a portion of future sinking fund installments. If the sinking fund has achieved an 8% return for five years, the funded ratio should be 100% at the end of the five years. If the returns have been 6%, or the issuer has failed to deposit the full amount of the required sinking fund installment in each year, the funded ratio will fall below 100%, because the value of the sinking fund assets in the numerator will fall below the discounted value of the liabilities in the denominator.

The funded ratio informs the investor of the percentage of pension liabilities (which are not being funded by future ordinary contributions) that will be covered by the investment of assets at the assumed rate. In 2010, according to the Public Fund Survey (based on a Boston College Public Plans Database) of 126 large pension systems that applied GASB reporting standards, the average funded ratio was 76%. A 100% funded ratio means that existing assets cover the present value

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139. GASB, Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans* ¶ 44 (Nov. 1994); GASB, Statement No. 27, *Accounting for Pensions by State and Local Governments* ¶ 39 (Nov. 1994).

140. Congressional Budget Office, *Economic and Budget Issue Brief: The Underfunding of State and Local Pension Plans* (May 2011); GASB Statement No. 25, ¶ 44, A-44; GASB Statement No. 27, ¶ 40, A-4.



of future benefits to be paid by the system. It is useful for investors to have disclosure of the issuer's funded ratio, either applying the same actuarial parameters as the plans in the Public Fund Survey or with disclosed assumptions that the analyst can adjust, in order to compare the issuer's funded ratio to the average in the Public Fund Survey. It is also important to have an analysis of the reasons the funded ratio is below 100%. The explanation may simply be lower investment returns during the recession, which are likely to improve in a better economy. The average funded ratio of the plans in the Public Fund Survey in 2001 was 102%, which was based on investment returns before the stock market decline and the recession.<sup>141</sup> However, the reason for a lower funded ratio may be that when the funded ratio was higher, the system increased benefits or lowered contributions, and the investor should be informed of steps being taken to improve the funded ratio. Another reason for a funded ratio dropping below 100% may be that the actuarial assumptions have turned out to be incorrect. Unfunded actuarial costs can result from assumptions about either assets or liabilities. In any case, they require recalibration, and it may be important for investors to be informed of adjustments being made in order to increase the funded ratio with higher contributions that take account of revised assumptions.<sup>142</sup>

Disclosure of the funded ratio for only the one year that represents the reporting period immediately prior to the date of the final official statement may be inadequate. The trend of the funded ratio over a number of years can be important. On the one hand, if the funded ratio trends up and down with the stock market and the economy, a plan that is relatively healthy may be down in a given year as a result of rates of return on investments that may trend upward again when the economy improves. In that case, a funded ratio that drops below the ratio for the prior year may be inconsequential. On the other hand, a trend line that is steadily declining, regardless of the stock market and economy, suggests that the pension system is not collecting annual contributions in an amount necessary to fund liabilities. NABL Considerations recommends reporting ten years of the funded ratio. The funded ratio can be expressed as a dollar amount. The "unfunded actuarial accrued liability" (UAAL) is the difference between the actuarial value of assets and the actuarial accrued liability (liabilities minus assets). Whether stated as a ratio or a dollar amount, the disclosure has no real meaning unless the investor or analyst is provided the actuarial assumptions that are used to determine assets and liabilities.

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141. *Id.* See also MUNNELL, *supra* note 134, at 59–60.

142. J. PENG, STATE AND LOCAL PENSION FUND MANAGEMENT 71–72 (2009).

### **[A] Measuring the Present Value of Future Pension Liability**

An important policy consideration for GASB in setting reporting standards, for both the legal entity that constitutes the pension plan and the governmental unit that makes required payments to the plan, is the extent to which GASB should use its jurisdiction to define generally accepted accounting principles that have the effect of dictating the assumptions used by actuaries in their procedures to project pension plan liabilities, and to calculate the ability of plan assets to fund all or a portion of the liabilities. The actuarial assumptions, in turn, inform the government employer of the amount that should be budgeted by the governmental unit in each fiscal year for the annual payment of the normal cost and the amortization of unfunded liabilities. In 1994, when it adopted GASB Statement No. 25 for financial reporting by the plan and GASB Statement No. 27 for pension accounting by state and local government employers, GASB decided to set parameters for permissible methods of calculation made by actuaries, but otherwise to allow some leeway in the procedures to be applied. If actuarial assumptions were within the parameters, the resulting numbers could be used in the financial statements for financial statement reporting to meet GASB's generally accepted accounting principles.

The topics covered by the 1994 GASB parameters were (1) benefits to be included, (2) actuarial assumptions, (3) economic assumptions, (4) actuarial cost methods, (5) actuarial value of assets, (6) the employer's annual required contribution (ARC), and (7) contribution deficiencies or excess contributions. If an investor or analyst saw that the actuarial calculations were used in financial reports attached to the official statement for the financing at hand, the investor or analyst was in a position to conclude that the funded ratio and the unfunded actuarial accrued liability in the official statement could reasonably be compared to the numbers in the Public Fund Study, which also complied with the GASB parameters. Under the new guidance in GASB Statement No. 67 and GASB Statement No. 68, the concept of parameters is not applied. The process of measuring liabilities under GASB Statement No. 67 and GASB Statement No. 68 involves three basic steps:

- (1) Projecting future benefit payments for current and former employees and their beneficiaries,
- (2) Discounting those payments to their present value, and

- (3) Allocating the present value over past, present, and future periods of employee service.<sup>143</sup>

Regarding the first step, GASB Statement No. 25 had included a policy determination in the treatment of projected future benefits. It is possible to compute a stream of benefits for current employees and retirees (or vested terminated employees) based on salary, age, sex, length of service, and assumptions about wage growth and inflation, and about the probability of dying, retiring, or receiving disability payments. Two concepts are debated in the literature to describe the benefits to be included. The accumulated benefit obligation (ABO) approach limits the components of pension benefits to the benefits paid to retired or vested former employees, and the benefits earned to date based on their current salaries and years of service. The projected benefit obligation (PBO) approach adds to the accumulated benefits the effect of future salary increases on the value of pension rights already earned by active workers. In 1994, GASB could have decided that either the ABO or the PBO approach was within acceptable parameters. However, GASB Statement No. 25 opted for the PBO. The effect of including projected salary increases was to increase the amount of accrued liability.<sup>144</sup> For the most part, the 2012 guidance left in place the PBO method of determining pension benefits to be included in the measurement of liabilities.

It is in the second and third steps for the measurement of liabilities that GASB significantly tightened procedures by the adoption of the 2012 statements. GASB Statement No. 67 has an effective date for pension plans in fiscal years beginning after June 15, 2013 (fiscal years ended June 30, 2014 or later). GASB Statement No. 68 has an effective date for state and local government employers in fiscal years beginning after June 15, 2014 (fiscal years ended June 30, 2015 or later).

Prior to the effective dates of GASB Statement No. 67 and GASB Statement No. 68, the discount rate that was applied was a discount rate equal to the long-term expected rate of return on the investment of the pension plan assets. This approach continues to be the starting point. To the extent that a pension plan's net position and projected normal contributions associated with active and inactive employees is expected to fully cover projected benefit payments (PBO calculation), the long-term expected rate of return will be used. If plan net position and normal contributions related to active and inactive employees is not projected to be greater than or equal to the projected benefit

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143. GASB, *New GASB Pension Statements to Bring About Major Improvements in Financial Reporting* (June 2012).

144. See MUNNELL, *supra* note 134, at 50–51.

payments, then the discount rate under the 2012 guidance will be required to be based on a high-quality, tax-exempt municipal bond rate (an average rating of AA/Aa or higher, equivalent ratings) for an index of twenty-year general obligation bonds. The policy behind the new standard is to allow a higher discount rate for funded liabilities than for unfunded liabilities, thereby creating an incentive for state and local governments to fund pension liabilities. The effect of the bifurcated discount rate is to project a crossover date when invested assets will no longer fund liabilities. The discount rate used will be a single rate that is equivalent to using (1) the long-term expected rate of return on plan investments for so long as assets are projected to be able to pay benefits, and (2) the high-quality municipal bond index rate for payments after plan assets are projected to be exhausted.

After projected benefits are discounted to a present liability, the third step is to assign portions of the aggregate amount of present liability to each year of assumed employment. GASB Statement No. 25 had used parameters to allow five different methods. The implication of choosing one method over another is to weight years in the employment cycle differently, depending on the chosen method, and the choice could result in a curve sloping upward if benefit payments were lighter in the earlier years, or sloping downward if payments were lighter in the later years. In 2012, GASB chose one of the five methods to be used by all government employers, the “entry age actuarial cost method.” The entry age normal (EAN) method assigns an equal percentage of liability to each year of employment beginning in the year of entry into employment. The effect on a graph is to produce a straight line. The most frequently used alternative method of assigning liabilities to years of employment was the projected unit credit (PUC), which assigned low payments to the early years of employment and increasingly higher payments in later years. In 2010, of the ten worst funded plans, four had adopted the PUC cost method.<sup>145</sup> In its cease-and-desist order against the state of Illinois for material misstatements about pension obligations in its disclosure documents, the SEC was highly critical of Illinois’ choice of the PUC cost method, adding: “Compared to an EAN approach, the PUC method results in less funding for active employees, accumulates assets more slowly, produces more volatile measures of contribution rates, and results in rising rather than level contribution rates.”<sup>146</sup>

Commentators have different views on the effect of GASB Statement No. 67 and GASB Statement No. 68 on reporting, funding, and

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145. MUNNELL, *supra* note 134, at 52, 78.

146. *In re State of Illinois*, SEC Cease-and-Desist Order, Securities Act Rel. No. 15,237, ¶ 9.f. (Mar. 11, 2013) [hereinafter *Illinois Cease-and-Desist Order*].

disclosure, but GASB itself stated its belief in 2012 that there would be marked improvements:

The guidance contained in these Statements will change how governments calculate and report the costs and obligations associated with pensions in important ways. It is designed to improve the decision-usefulness of reported pension information and to increase the transparency, consistency, and comparability of pension information across governments.<sup>147</sup>

One estimate is that there will be a significant decrease in the reported funded ratios, and that the average funded ratio of the 126 pension plans in the Public Fund Survey, which was described earlier, would drop from 76% in 2010, under the 1994 guidance, to 57%, under the 2012 guidance.<sup>148</sup> The new calculation of a funded ratio, however, does not change the actual liabilities. \$1,000 owed in 2020 under the 1994 assumptions is still \$1,000 owed under the 2012 assumptions.<sup>149</sup> The desired effect of lower funded ratios is to encourage governments to increase contributions to the plan. Material disclosure under the 2012 guidance is similar to material disclosure under the 1994 guidance. Investors and analysts should be given information related to the funded ratio to allow inferences about the reasons for the funded ratio, whether healthy or unhealthy, steps being taken to improve the funded ratio, and enough information on the measurements to allow investors and analysts to be able to make any necessary adjustments to allow comparisons with other plans.

### **[B] Asset Valuation under GASB Statement No. 67 and GASB Statement No. 68**

Pension plan assets include cash and cash equivalents, receivables, and investments. For reporting purposes, receivables and investments are to be broken down into their components.<sup>150</sup> Valuation under the 1994 guidance was an actuarial valuation that smoothed investment return performance over multiple years, typically five years, to reduce annual return volatility. A percentage difference between net market value and net book value for each of the most recent five years was calculated. The resulting percentages were averaged for the

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147. GASB, *New GASB Pension Statements to Bring About Major Improvements in Financial Reporting* (June 2012).

148. MUNNELL, *supra* note 134, at 70–72.

149. Munnell, Aubry, Hurwitz & Quinby, *How Would GASB Proposals Affect State and Local Pension Reporting?* (Center for Retirement Research at Boston College, June 2012 & updated Sept. 2012).

150. GASB Statement No. 67, ¶ 15.

five-year period and applied to the valuation year's market value of assets to arrive at an actuarial value. Thus, only 20% of investment gains or losses for the current year were taken into account for the current year valuation. Smoothing had the benefit of allowing more stable predictability for purposes of budgeting the employer's annual contribution.

GASB Statement No. 67 eliminates smoothing in favor of marking to market, and therefore, implicitly ties budgeting more directly to the prior year's investment performance, which, GASB believes, improves transparency. Paragraph 18 of GASB Statement No. 67 provides:

[P]ension plan investments—whether equity or debt securities, real estate, investment derivative instruments, or other investments—should be reported at their fair value at the end of the pension plan's reporting period. The fair value of an investment is the amount the pension plan could reasonably expect to receive in a current sale between a willing buyer and a willing seller—that is, other than in a forced or liquidation sale. Fair value should be measured by the market price if there is an active market for the investment. If such prices are not available, fair value should be estimated.

Marking to market will result in more pronounced fluctuations in the funded ratio, but from an investor's perspective, marking to market is probably more useful disclosure, and it increases the importance of disclosing the funded ratio over a number of years. Marking to market will also have an impact on calculating the crossover date when assets will not fund liabilities, and, thus, when the discount rate changes to the rate of the high-grade municipal bond index.

### **§ 8:5.3     *The Pension System, Governance, Plan Benefits***

#### **[A]   Plan Structure**

In a routine financing, official statement disclosure is approached by an introduction to the issuer, and a description of the project, the terms of the bonds, sources of debt repayment, debt coverage, and the security for the bonds. While there are concepts that are unique to pension plans, including those introduced above, pension plan disclosure will probably follow a similar progression with a description of the pension system that administers the plan, the plan benefits, the sources of plan funding, budgeting for contributions, investment of assets, funded ratios, legal protections of the plan assets, etc. At the outset of making disclosure, it should be noted that pension managers distinguish the terms "pension plan," "pension fund," and "pension system." The pension plan is the program that offers benefits to

eligible participants, and it is the plan that defines who the participants are, the nature of the benefits, and who is responsible for financing the benefits. The plan sponsor is the government entity that creates the plan. The pension fund refers to the irrevocable trust that holds the assets of the plan, and is technically an accounting concept. The pension system is the legal entity that is the fiduciary created by the plan sponsor to administer the plan, or plans. The pension plan ordinarily is not administered by the government sponsor. Instead, the sponsor usually creates a public employee retirement system governed by a board of trustees, who are either elected by plan members or appointed by the plan sponsor.<sup>151</sup>

Pension benefits provided by employers generally are divided into two broad categories. In a defined benefit plan, the employer guarantees a certain level of pension benefits to the employee. GASB Statement No. 67 defines such plans as providing defined benefit pensions “for which the income or other benefits that the plan member will receive at or after separation from employment are defined by the benefit terms. The pensions may be stated as a specified dollar amount or as an amount that is calculated based on one or more factors such as age, years of service, and compensation.”<sup>152</sup> In a defined contribution pension, the pension plan establishes an individual account for each plan member, defines the contributions the employer is required to make, and provides that the pension a member will receive depend on contributions made by the employer or employee, and the actual earnings on investments of those contributions. The public pension system may establish a defined benefit plan or a defined contribution plan, or a combination of both.

Pension managers, and GASB Statement No. 67, classify defined benefit pension plans according to (1) the number of employers whose employees are provided with pensions through the pension plan, and (2) whether pension plan obligations and pension plan assets are shared. Financial reporting, notes to the financial statements, and required supplementary information to the financial statements will vary by a plan’s classification. A single-employer plan has a defined benefit plan to provide pensions to the employees of only one employer. A multi-employer plan is classified as an “agent multi-employer plan” if the assets of a multi-employer defined benefit pension plan are pooled for investment purposes, but separate accounts are maintained for each employer so that each employer’s share of pooled assets is legally available to pay the benefits of only its own employees. The

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151. PENG, *supra* note 142, at 10–11.

152. GASB Statement No. 67, ¶ 51.

pooling is to achieve administrative efficiency. If the pension obligations to the employees of more than one employer are pooled, and pension assets can be used to pay the benefits of employees of any employer that provides pensions through the pension plan, the plan is considered to be a “cost-sharing multi-employer defined benefit pension plan.”<sup>153</sup>

Census Bureau data allows some generalizations about the breakdown of plan classifications. There are approximately 50,000 state and local governments that issue municipal securities, but, in 2005, there were only 2,656 state and local public pension systems (222 state and 2,434 local). Of the local systems, 365 were in Illinois and 928 in Pennsylvania. Approximately, 83% of all public pension plan assets were held by state pension systems, and 84% of members were beneficiaries in state pension systems.<sup>154</sup> In the case of teachers, although there are fourteen large city school districts that have independent plans, there are twenty-seven states that have statewide plans exclusively for teachers, and the remaining twenty-three states have statewide plans for both teachers and other types of employees. It follows that in many cases, a portion of official statement disclosure will be dependent on sources other than the issuer of the municipal securities.<sup>155</sup>

### **[B] Governance**

GASB Statement No. 67 requires that the notes to the financial statements for pension plans include “[i]nformation regarding the pension plan’s board and its composition (for example, the number of trustees by source of selection or the types of constituency or credentials applicable to selection).”<sup>156</sup> Depending on the circumstances, the lawyer drafting pension plan disclosure to appear in the front part of the official statement may want to provide additional information. For example, if it is clear from a description of the board of trustees that none has investment management experience, the discussion of governance could include information about the professional qualifications of key staff personnel. The GFOA, in a Recommended Practice publication, has stated that an optimal size for the board of trustees is between seven and thirteen members, depending on the size and complexity of the pension system.<sup>157</sup> The Recommended Practice further states: “Board composition should reflect the varied interests of those responsible for funding the plan and should

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153. *Id.*, ¶¶ 8–10.

154. U.S. Census Bureau, State and Local Government Employee-Retirement Systems Survey, 2004 and 2005.

155. PENG, *supra* note 142, at 14–17.

156. GASB Statement No. 67, ¶ 30.

157. GFOA, Recommended Practice, Governance of Public Employee Post-Retirement Benefits Systems (2010).



include plan participants and retirees, citizens of the governmental unit, and officers of the plan sponsor, as well as independent directors. This assures balanced deliberations and decision making." A state pension system is likely to have oversight by a legislative committee, an independent pension commission, or both, but local pension system disclosure may benefit from a brief description of risk management or any independent oversight.

Any known conflicts of interest may require disclosure, including relationships with financial or investment advisers. As with disclosure generally, red flags should be pursued. Sections 12:4.3 and 12:7.2 describe the types of conflicts of interest that are likely to occur between pension system officials and their advisors. In the wake of the scandal involving the former chief executive officer of the California Public Employees' Retirement System (CalPERS) and a pension fund placement agent, which has resulted in a SEC injunctive action<sup>158</sup> and a grand jury criminal indictment,<sup>159</sup> more states are requiring disclosure of pension system service provider fee arrangements.<sup>160</sup> Useful disclosure would include a reference or an Internet link to publicly available sources, particularly if the information can provide insights into investment policies of the system.

### **[C] Pension Benefits**

Taxpayers, elected officials, and plan beneficiaries may appreciate detailed information about the defined pension plan benefits, but in most cases a brief summary should be sufficient for investors. Information that is material is the information that is necessary for the investor to analyze pension costs. The funded ratio is a starting point. The denominator of the funded ratio is determined by the discounted cost of the future stream of pension benefit payments, and these future benefits depend on a set of actuarial assumptions. In order for the investor to evaluate the meaningfulness of the funded ratio, it may be important for the investor to review the assumptions. For example, historically, 100% of the annual required contributions (ARC) were paid to the Rhode Island Employees' Retirement System, which resulted in a favorable funded ratio. However, the ARC was based on outdated mortality tables, and when the assumptions were adjusted in 2010, the funded ratio was recalculated to be 46%.<sup>161</sup> Faulty assumptions can result in unreasonably low cost projections and hide an unfunded liability. NABL Considerations suggests that the

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158. SEC v. Arvco Capital Research, LLC (D. Nev.), SEC, Litigation Release No. 2012-73 (Apr. 23, 2012).

159. *Calpers Ex-CEO Faces U.S. Charges*, WALL ST. J., Mar. 19, 2013.

160. See, e.g., MASS. GEN. LAWS ch. 32, § 23-B.

161. MUNNELL, *supra* note 134, at 85.

official statement “[d]escribe the actuarial assumptions (economic and demographic) employed by the actuaries and the methodology for reviewing/updating such assumptions and the process of determining the actuarial assumptions to be used.” Disclosure can be made by a summary in the official statement or by reference to a Pension Plan Actuarial Report, which, along with other reports or studies, may be located on the issuer’s website.

If circumstances warrant additional disclosure to provide investors with the ability to drill down into the implications of plan benefits, an organizing reference (in addition to the funded ratio) is the formula used to calculate normal retirement benefits. A typical formula to determine the normal “defined benefit” is to multiply the final average salary (FAS) by years of credited service. This result is then multiplied by a “benefit multiplier.” If the FAS is \$50,000, the number of years of credited service is 30, and the multiplier is 1.5%, the normal annual retirement benefit will be \$22,500. A small increase in the multiplier can result in a large increase in the normal benefit. Thus, if the multiplier is adjusted from 1.5% to 1.65%, the normal benefit in the example will be increased by 10% to \$24,750. Several factors in the design of plan benefits affect the multiplier. For example, if employees make contributions to the plan, the multiplier is likely to be higher, but if the employer provides federal Social Security benefits, the multiplier is likely to be lower.<sup>162</sup>

In the 1990s, when a number of plans had a funded ratio of 100% or higher, benefits were increased by adjusting the multiplier upward, with the result that after the stock market decline and the recession, their funded ratios dropped significantly. Therefore, written policies and procedures to control decisions for adjusting benefits can be important. The GFOA recommends that governmental units “[h]ave all benefit enhancements actuarially valued before they can be approved in order to ensure a complete understanding of their long-term financial impacts.”<sup>163</sup> An actuarial valuation allows the pension system and the sponsor to consider the effect of an enhancement on normal costs for calculating the annual required contribution, and the decline in the funded ratio if the contributions are not immediately instituted. Cost-of-living adjustments (COLAs) for inflation can have a significant impact on pension costs, particularly if they are automatic. If a plan allows some level of discretion for the system to make COLAs, an actuarial evaluation can be made and increases in benefits given when the plan is well-funded. The final average salary, or FAS, should also be the subject of policies and procedures. The FAS can be

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162. PENG, *supra* note 142, at 30–33.

163. GFOA, Recommended Practice, Essential Design Elements of Defined Benefit Retirement Plans (2008).

substantially increased, above what is expected from normal salary increases, if the FAS includes unusually large overtime payments, unused sick leave, or unused vacation time, or if there is a disproportionate spike in the salary for the final year of employment. One control that can be established is to increase the number of years over which salaries are averaged to calculate FAS.<sup>164</sup> In most cases, detailed information about pension benefits may not be material, but red flags could provide reasons for increased disclosure.

#### **[D] Legal Protection of Plan Benefits**

In order to evaluate the credit of a new issue of municipal securities, it is material for investors to have information that allows them to determine whether revenues that are expected to pay debt service on the securities are subject to secured claims with a priority over debt service. A pledge of revenues to secure bondholders does not necessarily override other claims to the same sources of funds. The payment of the normal cost of pension plans and amortization of unfunded liabilities may come ahead of the claims of an indenture trustee. A related issue arises if the actuarial value of future pension plan benefits becomes too high in relation to plan assets, and the government sponsor attempts to amend pension benefits for current employees. In the aftermath of the recession, governors, legislators, and other public officials in numerous states proposed modifications to benefits or contributions to pension plans, including a reduction of benefit levels, increased employee contributions, and modifications to the components of the normal benefit formula (FAS, years in service, or the multiplier). As of 2011, about two-thirds of the states had made changes to pension plans in the aftermath of the recession. Most were directed at future employees, but some affected current employees and retirees.<sup>165</sup> Proposals for benefit changes for future or present employees and pending litigation challenging the legality of plan modifications may be material to investors.

Except for the requirements of the Internal Revenue Code related to deferral of tax liability, state and local pension plans are, for the most part, not regulated by federal law, and questions of a state's ability to amend pension plans, or change vested rights, is subject to the jurisdiction and law of each state. The large majority of states have abandoned the concept of pension plans as a mere gratuity of the

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164. Peng & Boivie, *Lessons from Well-Funded Public Pensions: An Analysis of Six Plans that Weathered the Financial Storm* (National Institute on Retirement Security June 2011).

165. Staman, *State and Local Pension Plans and Fiscal Distress: A Legal Overview*, Cong. Research Service Rept. for Congress, 4 (Mar. 31, 2011).

government, which can be changed at will, in favor of a characterization of plan benefits as deferred compensation that the employee is entitled to for work that has already been performed. This perspective leads many state courts to view pension plans as a contract between the government and the participant, or, in some courts, a property right. If there is a contract, the issue is whether an attempted modification of the contract is an impairment of contract in violation of the Contract Clause in Article I, Section 10, Clause 1 of the United States Constitution. Contract Clause jurisprudence involves determining whether a state law creates a contract and whether, under the circumstances, there is some overriding public purpose that can interfere with contractual relations. In at least six states, the state constitution has its own provision protecting public pension plan beneficiaries.<sup>166</sup>

The Illinois constitutional language is as follows:

Membership in any pension or retirement system of the State, any unit of local government or school district, or any agency or instrumentality thereof, shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired.<sup>167</sup>

This language creates impairment-of-contract jurisprudence in Illinois that may or may not track the precedents under the U.S. Constitution. The Illinois provision (and others like it) also raises the issue of its effect on priorities between pension and debt service obligations. It is not difficult to see the potential collision between the issuer's obligation to the beneficiaries of its pension plans and the holders of its debt, and the problems in drafting disclosure when the law of priorities is not clear. The importance of facing necessary disclosure about potential legal consequences increases when the financial health of the governmental unit is decreasing. The SEC's findings in its 2013 enforcement action against Illinois recognized the issue in the following statement:

The Structural Underfunding of the pension systems and the State's increasing inability to afford contributions created the significant risk that the State would be unable to satisfy its competing obligations. This underfunding also compromised the creditworthiness of the State and increased the State's financing costs.<sup>168</sup>

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166. *Id.* 4–6. The six states with constitutional provisions are Alaska, Arizona, Hawaii, Illinois, Michigan, and New York.

167. ILL. CONST., art. XIII, § 5.

168. Illinois Cease-and-Desist Order, *supra* note 146, at ¶ 10.c.

It should also be recalled, from section 8:5.1, that the GFOA's Recommended Practice on disclosure of pension funding obligations mentioned the "crowding out" issue as one factor in considering the necessity for, and extent of, disclosure.

What state constitutions giveth, they may also taketh away. Pension plans may be contracts of the government protected by state or federal contract clauses, but many states also have a strong tradition of constitutional case law upholding the principle that a sitting legislature cannot constitutionally bind a future legislature. The constitutional structure for issuing contractually enforceable general obligation bonds is an important exception, but multiyear state or local "funding plans" may not be binding on future legislatures, and may have characteristics of lease obligation debt that is subject to appropriations. The SEC, in its 2010 enforcement action against New Jersey, made the following finding:

Although bond offering documents disclosed that the State was required to contribute to [the Teachers' Pension and Annuity Fund and the Public Employees' Retirement System] at an actuarially determined rate and discussed the budget process generally, bond offering documents did not adequately disclose that the amount actually contributed to the pension plans is subject to the Governor's budget request and annual appropriations by the State legislature. . . . *In adopting the budget, the legislature is not required to follow the recommendations of the actuaries or the Governor in determining the State's required contribution to the pension plans.*<sup>169</sup>

The New Jersey Cease-and-Desist Order discusses a five-year "phase-in plan" initiated in fiscal year 2004 under which the legislature was to make increasingly higher percentages of the statutory contribution until, in five years, the state would be at 100% of the statutory contribution. The SEC notes that the increasing contributions would be subject to New Jersey Constitutional provisions restricting each legislature's ability to mandate spending by future legislatures.<sup>170</sup> The SEC's reference to the constitutional issue is a reminder that drafting disclosure statements about future legislative commitments should be made with care. It is difficult to write official statement disclosure about pension funding plans without making "forward statements," and NABL Considerations should be

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169. *In re* State of New Jersey, SEC Cease-and-Desist Order, Securities Act Rel. No. 9135, ¶ 32 (Aug. 18, 2010) [hereinafter New Jersey Cease-and-Desist Order] (emphasis added).

170. *Id.* ¶ 28.

consulted for guidance in making forward statements when making pension funding disclosure.

The working group drafting pension funding disclosure may easily find itself in a circumstance in which legislation has been proposed, introduced, or enacted to modify pension rights, and litigation may be threatened or initiated, but no final judgment of the state's highest court has been rendered. Some courts may apply a strict Contract Clause analysis to prohibit any modification of pension funding obligations, or reach a similar conclusion interpreting constitutional clauses protecting pension plans from adjustment.<sup>170.1</sup> In 2015, the Illinois Supreme Court held that certain legislation enacted by the Illinois legislature in 2014 was unconstitutional under article XIII, section 5 (the "pension protection clause" quoted above) as it applied to state workers, who first made contributions to one of the state retirement systems before 2011 and were entitled to retirement annuities.<sup>170.2</sup> The retirement annuity to which an employee was entitled was based, in part, on a formula related to final average compensation, total time of credited service, and whether the retiree was eligible for federal Social Security. Retirement system members could receive up to 75% of their final average compensation, and the annuity payments were subject to a 3% automatic annual increase. The legislation would have applied a comprehensive set of provisions designed to reduce annuity benefits, including a revision of the 3% annual increase. The Illinois Supreme Court rejected the state's argument that the pension protection was subject to reserved sovereign police powers, and determined that the pension protection clause meant exactly what it says. If something qualifies as a benefit of the enforceable contractual relationship resulting from membership in one of the state's pension or retirement systems, it cannot be diminished or impaired.

Under a nuanced approach, which follows twentieth-century Contract Clause analysis,<sup>170.3</sup> an attempt by a state to modify its own contracts (as an interested party) will avoid being an unconstitutional impairment only if there is a showing that an important public purpose is at stake. The Supreme Court of Puerto Rico took this approach in 2013 upholding the constitutionality of retirement system reform as a reasonable and necessary means to address the financial crisis threatening the actuarial solvency of the pension system.<sup>170.4</sup> Under this line of reasoning, state and local governments have a

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170.1. See, e.g., *Fields v. Elected Officials' Ret. Plan*, 320 P.3d 1160, 1163 (Ariz. 2014); *Kanerva v. Weems*, 13 N.E.3d 1228 (Ill. 2014).

170.2. *In re Pension Reform Litig.*, 2015 IL 118585.

170.3. See *U.S. Trust Co. v. New Jersey*, 431 U.S. 1 (1977).

170.4. *Trinidad Hernandez v. Commonwealth*, 188 D.P.R. 828 (2013).

fundamental obligation to provide essential public services, and, if requiring public funds to be used to pay pension benefits means the public will be denied these essential services, a reasonable contractual modification will be upheld.<sup>170.5</sup> In a state that is likely to balance competing interests, drafting disclosure requires care in stating the facts without speculating on an unknown outcome, but the task may be aided if a law firm provides a reasoned opinion, or summary of the judicial activity, that can be quoted.

### [E] Investment Management

Investment management disclosure may include a description of the individuals who are responsible for managing the investment of the pension plan's assets, and may mention investment advisers or other professionals involved with the managing of assets. If relationships involve conflicts of interest, it is this part of disclosure that the SEC will likely point to as containing material omissions of information. Closely related to the description of personnel is a summary of the board of trustees' investment policies, which may be a separate document that can be easily linked or referenced. The statement of investment policies is a formal summary of the board's investment goals, objectives, strategies to control risks, asset allocation policies, and risk tolerance. Depending on the circumstances, an asset allocation policy that permits alternative investments, such as private equity, hedge funds, and real estate, may lead to disclosure of allocation by classes and performance to allow investors to judge whether the assumed rate of return is likely to be achieved.

Section 8:5.2[B] on asset valuation described the decision of GASB in Statement No. 67 to switch from actuarial valuation, permitting smoothing over a period of years, to a policy of marking to market. The immediate recognition of asset gains and losses results in a funded ratio that clearly demonstrates the direct relationship between the value of plan assets and the rise and fall of the stock market, or other market indicators.<sup>171</sup> A decision by a pension system or government sponsor to change valuation methods on its own, however, can be a disclosure red flag. A major theme in the New Jersey Cease-and-Desist

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170.5. Spiotto, *How Municipalities in Financial Distress Should Deal with Unfunded Pension Obligations and Appropriate Funding of Essential Services*, 50 WILLAMETTE L. REV. 515 (2014). The article is available on the website of Chapman and Cutler LLP. See [www.chapmanstrategicadvisors.com/media/publication/13\\_Chapman\\_Municipalities\\_in\\_Distress\\_and\\_Unfunded\\_Pension\\_Obligations\\_WLR\\_CSA\\_2014.pdf](http://www.chapmanstrategicadvisors.com/media/publication/13_Chapman_Municipalities_in_Distress_and_Unfunded_Pension_Obligations_WLR_CSA_2014.pdf).

171. Munnell, Aubry, Hurwitz, Medenica, & Quinby, *The Funding of State and Local Pensions: 2011–2015*, at 3 (Center for Retirement Research at Boston College, May 2012).

Order was the state's decision in 2001 to retroactively revalue plan assets for year 1999 to reflect asset value when the stock market was high and to use that value for purposes of the 2001 five-year smoothing, rather than the 1999 actuarial value that would have the effect of including earlier years in which market value lagged behind the peak:

On June 29, 2001, the State legislature approved legislation . . . that, effective November 1, 2001, increased retirement benefits for employees and retirees enrolled in TPAF [the Teachers' Pension and Annuity Fund] and PERS [the Public Employees' Retirement System] by 9.09 percent. In order to fund the enhanced benefits, without increased costs to the State or taxpayers, the legislation revalued TPAF and PERS assets to reflect their full market value as of June 30, 1999, near the height of the bull market. Bond offering documents did not disclose the retro-active mark-to-market revaluation of the pension assets under the 2001 legislation until March 2003 or the reason for the revaluation. More specifically, bond offering documents did not disclose that the State used the market value as of June 30, 1999 in order to make it appear that the State could afford the benefit improvements.<sup>172</sup>

Asset valuation under GASB Statement No. 25 and GASB Statement No. 27 used GASB's parameter approach, which gave leeway to pension systems or sponsors to change the method of valuation. Permitted methods were reflected in the definition of "market-related valuation of plan assets": "A term used with reference to the actuarial value of assets. A market-related value may be market value (or estimated market value) or a calculated value that recognizes changes in market value over a period of, for example, three to five years."<sup>173</sup> The ability to choose allowed New Jersey to use the value that achieved its budgetary policy objectives, and there should have been clear disclosure of the revaluation and the state's objectives in making the revaluation.

### **[F] OPEBs and GASB Statement No. 45**

Other postemployment benefits (OPEBs) range from healthcare, to life insurance, to reimbursement for gym memberships, to survival benefits. Traditionally, governmental units paid for OPEBs on a pay-as-you-go basis, so the extent of accrued liabilities was not determined and reported in the financial statements. Funds were not put aside in trust to accumulate assets and generate investment returns. As a result, financial management and reporting failed to:

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172. New Jersey Cease-and-Desist Order, *supra* note 169, at ¶ 17.

173. GASB Statement No. 25, ¶ 44; GASB Statement No. 27, ¶ 39.



- Provide for and recognize the cost of OPEBs during the employment period when the related services were received by the employer;
- Make employer contributions based on and provide information about the accrued liabilities for promised benefits associated with past services; and
- Provide information to investors and other stakeholders about potential demands on the employer's future cash flows.

In 2004, GASB adopted its Statement No. 45 to provide generally accepted accounting rules for the financial reporting of a governmental unit's obligations to provide OPEBs.<sup>174</sup> GASB Statement No. 45 follows the pattern of GASB Statement No. 27, including the use of parameters, an accrual-basis measurement and recognition of OPEB costs over a period that approximates an employee's years of service, information about actuarial accrued liabilities, and calculation of the annual required contribution. Accordingly, the disclosure issues associated with OPEBs may be similar to those associated with pension funding.

### **§ 8:5.4 Government Funding of the Normal Cost and Amortization of Unfunded Liability**

#### **[A] The Lost ARC**

At the heart of pension funding disclosure is information describing the governmental unit's funding of its obligation to make contributions to the pension plan. Under GASB Statement No. 25 and GASB Statement No. 27, accounting principles were used to calculate (1) the value of assets and the actuarial value of pension benefits to determine the cost of normal plan benefits attributable to the current year and (2) the amount of outstanding unfunded liabilities remaining because of underfunding in prior years, a decline in the value of assets, or incorrect actuarial assumptions that implied there were fewer liabilities than was actually the case. The first amount is the "normal cost," which is the present value of the plan benefits accrued in a given year. GASB Statement No. 25 defined normal cost as "[t]hat portion of the Actuarial Present Value of pension plan benefits and expenses which is allocated to a valuation year by the Actuarial Cost Method."<sup>175</sup> All other things being equal, if this amount was paid by the sponsor in every year (and the rate of return on investment of plan assets was

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174. GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions* (June 2004).

175. GASB Statement No. 25, ¶ 45, A.3.

the expected rate of return), the plan would be 100% funded, as to each employee, on the actuarial date of retirement or termination. The second amount is a calculation of unfunded liabilities, and the relevant calculation is the proportion of unfunded liabilities that should be paid in each year to responsibly reduce the total amount of unfunded liabilities. Ideally, the unfunded liabilities would be completely paid over the course of a few years, and the only amount necessary for the governmental unit to budget in each subsequent year would be the normal cost. The 1994 standards provided parameters for amortizing the unfunded actuarial accrued liability (UAAL) that allowed an amortization period up to thirty years, but that was a rolling thirty years, meaning the UAAL will not necessarily be fully paid down in thirty years. The underlying theory was that, since the UAAL would not be paid in future years through the normal cost, it must be amortized over a reasonable period so that plan assets would eventually cover plan liabilities without placing unreasonable burdens on the budget in each year.

The accounting term used in the 1994 standards to capture these two amounts was the “annual required contribution” (ARC). The ARC was equal to the normal cost plus an installment to amortize the unfunded liability, accrued generally over the rolling thirty-year period. The ARC was an accounting calculation, but many governmental units have used the ARC for purposes of budgeting the amount to be appropriated in each fiscal year for payment to the pension plan—perhaps influenced by the word “required” in the defined term. In fact, state and local governments were not able to maintain full funding of the ARC in the aftermath of the stock market decline in 2001 and the economic crisis of 2008–2009, when there were both declining revenues to fund budgets and losses in the value of investments of pension plan assets. In 2001, the Public Pension Survey database indicated that the 126 pension plans in the survey funded 100% of the ARC, but in 2011 the amount was down to 79%. When the value of plan assets declines, the ARC goes up, and when the government does not pay 100% of the ARC, the ARC goes up further. The combined impact on budgets can be seen in the calculation of the ARC as a percent of payroll. In 2001, the ARC was 6.4% of payroll for the Public Pension Survey plans, and in 2011, the ARC was 15.7% of payroll.<sup>176</sup> Both the ARC and the actual contribution can be calculated as a percentage of payroll. NABL Considerations suggests the following disclosure:

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176. Munnell et al., *supra* note 171.

What percent of covered payroll does the ARC and the actual pension contribution represent? Has this amount been increasing in the last several years? If so, by what percentage?<sup>177</sup>

Any trend in the UAAL component of the ARC is important because it indicates whether the governmental unit is making progress in reducing the UAAL. GASB Statement No. 25 provided for disclosure of trends by implementing two required schedules in the Required Supplementary Information (RSI): a Required Schedule of Funding Progress and a Required Schedule of Employer Contributions. They were to appear immediately after the notes to the financial statements. The first was to provide historical trend information for the past six years of the actuarial value of plan assets, the actuarial accrued liability, the total unfunded actuarial liability (UAAL), the actuarial value of assets as a percentage of actuarial accrued liability (the funded ratio), the annual covered payroll, and the ratio of the UAAL to annual covered payroll.<sup>178</sup>

The second, the Schedule of Employer Contributions, was to include historical information about the ARC and the contributions made by the employer in relation to the ARC. The schedule presented the dollar amount of the ARC applicable to the fiscal year, and the percentage of that ARC that was recognized in the plan's statement of changes in plan net assets. Together, the schedules provided for a considerable amount of material information, including the trend in the funded ratio and the percentage of ARC paid, which was an indication of the employer's funding plan and whether it was maintaining a level of amortization payment to reduce the UAAL in an orderly manner.

In 2012, when GASB adopted Statement No. 67 and Statement No. 68, it decided to end the implication of the term "annual *required* contribution" from pension accounting principles because the ARC concept suggested that GASB was inserting itself into the funding process. The explanation given by GASB is as follows:

It is important to note that the new Statements relate to *accounting and financial reporting* issues only—how pension costs and obligations are measured and reported in audited external financial reports. The Statements do not address how governments approach pension plan *funding*—a government's policy regarding how much money it will contribute to its pension plan each year. While there has been a close relationship between how governments fund pensions and how they account for and report information about them until now, the new guidance establishes

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177. NABL CONSIDERATIONS, *supra* note 136, at 8.

178. GASB Statement No. 25, ¶ 19, ¶ 37.

a decided shift from the *funding-based* approach to an *accounting-based* approach. The Board crafted its new Statements with the fundamental belief that funding is squarely a policy decision for elected officials to make as part of the government budget approval process.<sup>179</sup>

Accordingly, GASB Statement No. 67 does not refer to “unfunded” actuarial accrued liability, or annual “required” contribution, but instead uses terms such as “total pension liability,” “plan net position,” “net pension liability,” and “actuarially determined contribution.” Total pension liability is the portion of the actuarial present value of projected benefit payments that is attributed to past periods of member services. The actuarially determined contribution is a “target” or “recommended” contribution to a defined benefit plan for the reporting period determined actuarially. The data presented in RSI schedules is based on the new terms, but the disclosure of material information continues to be comprehensive, and the trends are to cover ten years.

Despite the elimination of the ARC, the RSI does tabulate information about contributions. If a single-employer or cost-sharing pension plan does have an annual “actuarially determined contribution” (or if not actuarially determined, then the statutorily determined contribution), there is to be a ten-year RSI schedule showing:

- (1) the actuarially determined annual contribution (or, the statutorily determined contribution);
- (2) the amount of employer contribution actually made;
- (3) the difference between (1) and (2);
- (4) the payroll of employees covered by the plan; and
- (5) a ratio of (2) divided by (4).<sup>180</sup>

### **[B] Task Force Recommendations**

The decision by GASB to disconnect funding from accounting and reporting does not mean that a governmental unit cannot continue a funding policy based on the calculation of an ARC if that had been its prior reference for budgeting its pension plan contributions. However, the terms used for financial reporting will not automatically translate to the concepts the governmental unit intends to use for funding. For example, under the 2012 standards, plan assets are to be marked to market, which may be preferable for financial statements,

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179. GASB, *New GASB Pension Statements to Bring About Major Improvements in Financial Reporting* (June 2012).

180. GASB Statement No. 67, ¶ 32.

but the governmental unit may decide to retain the actuarial asset valuation of the 1994 standards with five-year smoothing in order to avoid budgetary volatility. In any case, funding policy will require more attention by each individual governmental unit under the 2012 standards.

To assist governmental units, a group of national associations that represent state and local governments formed a Pension Funding Task Force in 2012 to develop policy guidelines.<sup>181</sup> The Task Force recognized that the 2012 standards do not require a change in policies, but it recommended that the funding policy be based on the following five objectives:

1. Have a pension funding policy that is based on an actuarially determined contribution.
2. Build funding discipline into the policy to ensure that promised benefits can be paid.
3. Maintain intergenerational equity so that the cost of employee benefits is paid by the generation of taxpayers who receive services.
4. Make employer costs a consistent percentage of payroll.
5. Require clear reporting to show how and when pension plans will be fully funded.

The Task Force Guide continues with specific recommendations, but there are three conclusions that are relevant to disclosure. First, governmental units can continue calculating the ARC and related concepts from the 1994 standards if they determine to continue using those concepts for purposes of funding pension obligations. Second, the concepts used for purposes of funding are less likely to be the concepts used for accounting and reporting, and governmental units should recognize that funding concepts can be separate from terms used in accounting and reporting. Third, as implied in the fifth objective listed above, issuers and their disclosure counsel will have a heightened obligation to address disclosure, because different funding

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181. The organizations that formed the Task Force were the National Governors Association, the National Council of State Legislators, the Council of State Governments, the National Association of Counties, the National League of Cities, the U.S. Conference of Mayors, the International City/County Association, and the GFOA. Participants on the task force also included the National Association of State Auditors, Comptrollers and Treasurers, the National Association of State Retirement Administrators, and the National Council on Teacher Retirement. In 2013, the task force released its guidelines. *See* PENSION FUNDING: A GUIDE FOR ELECTED OFFICIALS; REPORT FROM THE PENSION FUNDING TASK FORCE 2013.

policies will obscure the clarity of comparable data among issuers, and difficulties experienced by investors and analysts should be viewed by issuers as an obligation to make funding policy and achievements sufficiently clear to allow objective analysis.

### **[C] Pension Obligation Bonds**

When a state or local government has increasing unfunded liabilities to the pension plan, the ordinary funding policy is to increase the annual payments used to amortize the unfunded liability. An alternative is to issue pension obligation bonds. In the simplest case, pension obligation bonds are general obligation bonds issued by a governmental unit that is the sponsor of a pension plan in order to fund the government's unfunded liabilities. The proceeds of the bonds are deposited with the pension system and added to the pension trust assets. The principal amount can be sized so that when the proceeds are invested at the assumed rate of return for plan assets, the return on the investments will be sufficient to pay the actuarial plan benefits. By increasing the assets of the plan (the numerator of the funded ratio) by this amount, the funded ratio can be raised to 100%. The reason the funded ratio is 100% is that the UAAL is fully funded after the issuance of the bonds.

By bringing the funded ratio to 100%, the issuance of pension obligation bonds has the benefit of assuring employees that postemployment benefits will be paid. In reality, the governmental unit has simply substituted an obligation to amortize the principal and interest on the pension obligation bonds for the prior obligation to fund the UAAL. The justification for the fiscal sleight of hand is an arbitrage play. If the rate of return on the investment of plan assets is higher than the debt service on the pension obligation bonds, the amount payable to amortize the bonds will be lower than the amount paid to fund the actuarial future plan benefits. Since the pension obligation bonds are arbitrage bonds, they are issued as taxable bonds, and the spread between the debt service on the bonds and the assumed rate of return on plan assets is narrower than if the bonds could have been issued on a tax-exempt basis. Maintaining a positive spread, therefore, requires successful investment in alternative investments that are likely to yield higher returns than taxable corporate bonds, which implies emphasis on private equity, hedge funds, real estate, etc. If the investment of assets is not successful, and an unfunded liability reappears, the governmental unit will be obligated to pay both the unfunded pension plan liability and the debt service on the pension obligation bonds. The arbitrage risk puts pressure on the pension system to invest in products that have the potential for high yields, but the normal portfolio diversification effect of investing plan contributions

over the time the contributions are made is absent because the investment managers will have a single lump sum to invest in the one year the pension obligation bonds are issued.<sup>182</sup>

Disclosure of outstanding pension obligation bonds, whether separately or by reference to the debt section of the issuer's official statement, should provide sufficient information for investors to evaluate the risk of the arbitrage play, and should not be obscured to prevent the investor from easily recognizing that the pension obligation bonds are a reason the issuer has a high funded ratio. If there are material covenants in the pension obligation bond trust indenture that affect the pension plan's benefits or its funding, they should be disclosed. Pension obligation bonds that are misused to avoid or postpone budget discipline are red flags that can lead to further disclosure.

In 2015, the Government Finance Officers Association (GFOA) recommended against issuing pension obligation bonds because they are dependent on investment returns that are very speculative and subject to risk. The following specific reasons were cited by the GFOA:

1. The invested [pension obligation bonds] proceeds might fail to earn more than the interest rate owed over the term of the bonds, leading to increased overall liability to the government.
2. [Pension obligation bonds] are complex instruments that carry considerable risk. [Pension obligation bond] structures may incorporate the use of guaranteed investment contracts, swaps or derivatives, which must be intensively scrutinized as these embedded products can introduce counterparty risk, credit risk and interest rate risk.
3. Issuing taxable debt to fund the pension liability increases the jurisdiction's bonded debt burden and potentially uses up debt capacity that could be used for other purposes. In addition, taxable debt is typically issued without call options or with "make-whole" calls, which can make it more difficult and costly to refund or restructure than traditional tax-exempt debt.

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182. See Burnham, *Risky Business! Evaluating the Use of Pension Obligation Bonds*, GOV'T FIN. REV. 12 (June 2003); California Debt and Investment Advisory Commission, *A Double-Edged Sword: The Economics of Pension Obligation Bond Financing for Local Governments* (Symposium, Oct. 24, 2012); Munnell, Calabrese, Monk & Aubrey, *Pension Obligation Bonds: Financial Crisis Exposes Risk* (Center for Retirement Research at Boston College, Jan. 2010).

4. [Pension obligation bonds] are frequently structured in a manner that defers the principal payments or extends repayment over a period longer than the actuarial amortization period, thereby increasing the sponsor's overall costs.
5. Rating agencies may not view the proposed issuance of [pension obligation bonds] as credit positive, particularly if the issuance is not part of a more comprehensive plan to address pension funding shortfalls.<sup>182.1</sup>

**§ 8:5.5      *Disclosure Implications of the SEC Enforcement Actions Against New Jersey, Illinois, and Kansas***

**[A]      *New Jersey***

The New Jersey Cease-and-Desist Order is about the state's taking a "pension holiday" from making annual contributions to its two largest pension plans that began in 1997 and, with minor exceptions, lasted nine years, to 2006. Between 1997 and 2001, when the stock market was bullish, the value of assets gave credibility to annual decisions not to make contributions, but beginning in 2001, the state resorted to gimmicks to conceal that it was not making contributions. The cease-and-desist order found that the state then made misrepresentations in bond offering documents that created the illusion that the state was making contributions. The enforcement action related to offering documents<sup>183</sup> for seventy-nine bond issues between 2001 and 2007 aggregating \$26 billion, and the misrepresentations were in connection with the underfunding of the state's two largest pension systems, the Teachers' Pension and Annuity Fund (TPAF) and the Public Employees Retirement System (PERS) (collectively, the "Plans"). Both Plans had a funded ratio of over 100% in 2001, but the effect of the failure to make contributions was such that in 2009, TPAF had a funded ratio of 63.8% (and a UAAL of \$18.7 billion), and PERS had a funded ratio of 56.4% (and a UAAL of \$8.2 billion).<sup>184</sup>

In 2001, when the Plans had a funded ratio of over 100%, the state legislature enacted legislation to increase retirement benefits for employees and retirees enrolled in the Plans by more than 9%. At the time, the state used the actuarial method of valuing assets with five-year smoothing. In order to justify the increased benefits, the legislation revalued the assets for the year 1999 by using the mark-to-market valuation method. In 1999, the stock market was near its

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182.1. Government Finance Officers Association, Pension Obligation Bonds (Jan. 2015), [www.gfoa.org/pension-obligation-bonds](http://www.gfoa.org/pension-obligation-bonds).

183. Offering documents included the preliminary official statement, the final official statement, and annual disclosure pursuant to continuing disclosure agreements.

184. New Jersey Cease-and-Desist Order, *supra* note 169, at ¶ 9.



peak, and by having a market value for 1999, rather than that year's lower actuarial value, the actuarial five-year value used in 2001 through 2003 had the benefit of the higher 1999 value. The 2001 legislation created "benefit enhancement funds" to set aside a portion of the increased assets, or the "excess valuation assets," which was a statutory term of art defined to mean the difference between the valuation assets and the actuarial accrued liability. Amounts in the benefit enhancement funds were to be used to pay the normal cost associated with the enhanced benefits. Each of the benefit enhancement funds was then credited with excess valuation assets from the contingent reserve funds in the Plans. The cease-and-desist order made a finding that disclosure of these actions was inadequate:

Bond offering documents did not disclose the reason for and impact of the retroactive mark-to-market revaluation of the pension assets. By revaluing TPAF and PERS assets and creating the [benefit enhancement funds] to fund the ongoing costs of the benefit enhancements, the State gave the false appearance that it could afford the increased benefits. The revaluation of the pension assets to reflect their full market value as of June 30, 1999 resulted in a significant difference between the actuarial value and market value of assets in TPAF and PERS. Because the State's contributions to TPAF and PERS are based on the actuarial valuation of assets, the revaluation created the false appearance that the plans were "fully funded" and allowed the State to justify not making contributions to the pension plans despite the fact that the market value of the plans' assets were rapidly declining.<sup>185</sup>

By not making any contributions to the Plans between fiscal year 1997 and fiscal year 2003, the state created no incremental increase to the assets of the Plans that could be used to generate investment returns to offset the normal cost in the following years. In fiscal year 2002, the actuaries informed the state that it would have to begin making contributions to pay the normal cost and to amortize actuarial accrued liabilities. For fiscal year 2003, the funded ratio of TPAF had declined to 92.7%, and the funded ratio of PERS had declined to 90.7%. However, the state was then subject to severe budget pressures, and it decided it would have to phase in the required statutory contributions over a five-year period—20% of the required statutory contribution in fiscal year 2004, 40% in 2005, 60% in 2006, 80% in 2007, and 100% in 2008. Each year that it was not paying the full statutory contribution, the state would be accruing actuarial liabilities. In fact, rather than phasing in the required statutory contributions, the state used the benefit enhancement funds as part of the phase-in

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185. *Id.*, ¶¶ 17–22.

plan. The state did not make contributions in fiscal years 2004 and 2005, and only minor contributions in fiscal year 2006. Again, the offering documents did not disclose adequately what, in effect, was a continuation of the pension holiday. The cease-and-desist order made the following findings:

Bond offering documents did not disclose that the State was not contributing to TPAF and PERS during this time. When assets from the [benefit enhancement funds] were used to fund the State's pension obligations in 2004, 2005, and 2006, funds were transferred from the [benefit enhancement funds] back to the Contingent Reserve Funds, the original source of assets in the [benefit enhancement funds]. These interfund transfers created the false appearance that the State was making contributions to TPAF and PERS, when no actual contributions were being made. Bond offering documents did not disclose that the [benefit enhancement funds] allowed the State to forego making contributions to TPAF and PERS. . . .

Although bond offering documents referenced the [benefit enhancement funds] in connection with the State's contributions, they never disclosed what they were, how they were being used, or why they were being used. Bond offering documents did not disclose that the State was using the [benefit enhancement funds] in conjunction with the five-year phase-in plan because of significant budgetary constraints, and was unable to contribute to TPAF and PERS.<sup>186</sup>

This last quoted finding of the SEC—that there was inadequate disclosure of what the benefit enhancement funds were, how they were being used, and why they were being used—raises the general subject of disclosure about the use of rising asset values to increase benefits for current and retired employees, rather than retaining the excess as an asset to offset future declines in the rate of return. NABL addresses this issue with the following disclosure recommendation:

Determine if a plan has an "excess earnings" policy (*i.e.*, earnings generated as the product of an investment rate that exceeds the assumed investment return) that are used for any purpose other than being retained as a plan asset and explain such policy, if any. Note the permitted and planned uses of such excess earnings and the impact of such use on the historical and projected health of the pension plan.

Some pension plans pay benefits if the plan has "excess earnings." Under actuarial theory, there are no excess earnings because the assumed rate of return presupposes volatility from year to year

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186. *Id.*, ¶¶ 31–32.

and thus better than expected results in one year are expected to be offset by lower than expected results in future years.<sup>187</sup>

NABL's recommendation that there be disclosure of the impact of the policy on the historical and projected health of the plan is responsive to findings in the New Jersey Cease-and-Desist Order that the bond offering documents failed to provide tables of trend information about the impact of the state's funding practices on plan assets and the health of the state's finances. The SEC noted that the bond offering documents did not include a key statistical table from GASB's Required Supplementary Information Schedule of Funding Progress. The RSI Schedule shows the UAAL, and the UAAL as a percentage of covered payroll, which is one measure of the significance of the UAAL relative to the capacity to pay it. The UAAL as a percentage of covered payroll for TPAF went from 0.0% in 2002 to 137.1% in 2007, and for PERS from 8.9% in 2002 to 112.8% in 2007.<sup>188</sup>

### **[B] Illinois**

The New Jersey Cease-and-Desist Order was about misleading information in bond offering documents related to a series of decisions to underfund pension plans. The Illinois Cease-and-Desist Order focused on the effects of omissions in preliminary and final official statements related to structural defects of the state's statutory funding plan. The Illinois Cease-and-Desist Order covered multiple bond offerings between 2005 and 2009 aggregating \$2.2 billion. Illinois provides funding for five retirement systems,<sup>189</sup> and the SEC found that, as of 2011, the systems collectively were underfunded by \$83 billion with a funded ratio of 43%.

In 1994, when the plans were underfunded by \$20 billion, the legislature enacted the Illinois Pension Funding Act (the Statutory Funding Plan), which established a fifty-year funding schedule that was intended to achieve a 90% funded ratio for each system by 2045. The Statutory Funding Plan called for the state to meet this target by contributing to the plans a level percentage of payroll each year sufficient to meet its goal. The actuarial value of plan benefits and the value of assets were determined in order to calculate a payroll percentage that, applied equally, would achieve the target in 2045. Rather than requiring this amount immediately, the level percentage of payroll calculation was to be phased in over a fifteen-year period so

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187. NABL CONSIDERATIONS, *supra* note 136, at D-5.

188. New Jersey Cease-and-Desist Order, *supra* note 169, at ¶ 39–40.

189. The five systems are the Teachers' Retirement System, the State Universities Retirement System, the State Employees' Retirement System, the Judges' Retirement System, and the General Assembly Retirement System.

that by 2010, the level percentage of payroll methodology would be applied between 2010 and 2045.

The SEC found that, as applied, the Statutory Funding Plan schedule increased the unfunded liability, underfunded the state's pension obligations, and deferred pension funding, which the SEC termed "structural underfunding" because the required contributions were insufficient in most years to prevent the growth of the unfunded liability. Under the schedule, contributions were insufficient to cover the normal cost and to amortize unfunded liability, which would be the calculation applying the GASB's actuarially required contribution (ARC). From 1996 to 2010, the state's unfunded liability increased by \$57 billion, and the SEC found that the driving force of the increase in unfunded liability was the state's insufficient contributions, not changes in benefits or market performance of investments.<sup>190</sup> Among the material omissions in the offering documents, the SEC found the following:

- The state did not disclose in its official statements its failure to contribute the full amount of the ARC, and the consequences of not contributing the full amount of the ARC.
- The state did not disclose that multiple aspects of the Statutory Funding Plan deferred pension contributions and increased the burden associated with the pension plans, such as the implications of spreading costs over fifty years, the fifteen-year ramp period, and the 90% funding target.
- The official statements cited a number of factors that, in the past, contributed to the increase in unfunded liability (statutory benefit enhancements and market performance), but did not disclose that the insufficient contributions were the primary driver of the increase.
- The state disclosed that its UAAL could increase in the future by a number of factors (decrease in investment performance, and changes in legislation, actuarial assumptions, inflation, benefits, or the state's contribution formula), but the state did not disclose that the primary factor affecting the UAAL would be its underfunding.
- The state failed to disclose the effect of its unfunded pension systems on its ability to manage other obligations.
- The state failed to disclose that structural underfunding risked exhaustion of the pension systems' funds, and the state would likely not be able to afford to pay the level of contributions

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190. Illinois Cease-and-Desist Order, *supra* note 146, at ¶¶ 8–10.

required by the Statutory Funding Plan, which, in turn, created a risk to bondholders.

Beginning in 2005, the state amended the Statutory Funding Plan, lowering the required contributions, or borrowed to cover payments.<sup>191</sup> The 2005 legislation created pension holidays by lowering the contributions in 2006 and 2007 by 56% and 45%, respectively. The lower contributions increased the unfunded liability, and when the ramp period was restored, it proceeded from the lower 2006 and 2007 levels. The SEC found that contrary to the state's Comprehensive Annual Financial Report, which stated that the pension holidays would be offset by increased contributions from 2008 to 2010, the legislation did not require increased contributions in those years.<sup>192</sup>

The Illinois Cease-and-Desist Order indicates that pension funding disclosure requires those who review the disclosure to be alert for omissions, and if there are red flags, to investigate the omission, to remedy the omission, and to consider possible disclosure of the implications of the information that is (or would have been) omitted. The enforcement action also highlights the difficulty in dealing with disclosure of schedules of future payments. The fact that scheduled payments are pursuant to legislation does not mean they are accurate, or that they will necessarily achieve the intended targets, or that they do not have implicit omissions about the consequences of pension funding based on the schedules.<sup>193</sup>

The enforcement actions against New Jersey and Illinois both emphasize the importance of policies and procedures, disclosure controls, training programs, and a designated disclosure committee as the best means to prevent misleading disclosure and an enforcement action. Throughout the findings, the SEC points to specific deficiencies in disclosures that, implicitly, could have been prevented if appropriate procedures had been put into effect. This theme relates back to the San Diego remedial actions discussed in section 8:2.1.

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191. While not at issue in the SEC's Illinois Cease-and-Desist Order, legislation was enacted in 2003 authorizing the state to issue \$10 billion in pension obligation bonds. Of the \$10 billion, only about \$7.32 billion was added to assets for the purpose of investing to reduce the unfunded liability. About \$2 billion was used to pay part of the state's pension contributions in fiscal years 2003 and all the State's obligation in 2004. \$481 million was used for capitalized interest, and debt service principal was back-loaded, so that half the principal repayment on the thirty-year bonds was to be repaid in the last five years. PENG, *supra* note 142, at 151.

192. Illinois Cease-and-Desist Order, *supra* note 146, at ¶¶ 15–17.

193. See section 8:3.4; NABL CONSIDERATIONS, *supra* note 136, at 2–3, D-4.

**[C] Kansas**

In 2014, Kansas became the third on the list of states subject to SEC cease-and-desist orders in connection with the SEC's nationwide probe of misleading statements in offering document disclosures related to pension funding liability.<sup>193.1</sup> At the time, the SEC cited a study showing that Kansas was the second-most-underfunded state-wide public pension system in the nation, surpassed only by Illinois. In Kansas, the Kansas Development Finance Authority (K DFA) issues bonds on behalf of the state and its agencies. The SEC found that eight series of bonds in 2009 and 2010 were issued by K DFA without disclosing the existence, or the significance, of the unfunded liability in the state's pension system known as the Kansas Public Employees Retirement System (K PERS) or the effect of the unfunded liability on the risk of nonappropriation of debt service payments by the state legislature. At the end of the 2008 calendar year, K PERS had a total retirement system UAAL of \$8.3 billion and a 59% funded ratio. At that time, the state's tax-supported debt was \$3.1 billion.

In addition to the structural issues that were identified in the Illinois Cease-and-Desist Order, the Kansas Cease-and-Desist Order identified a particular problem in Kansas: K DFA bonds are not general obligation bonds, but are revenue bonds dependent on an appropriation of debt service payments by the state legislature. The K DFA bonds do not have the constitutional protections of general obligation bonds supported by a pledge of full faith and credit in a state like New York.<sup>193.2</sup> The Kansas constitution substantially limits the ability of the state to issue bonds directly, and, therefore, the state raises capital through the issuance of K DFA revenue bonds that are subject to repayment by an appropriation of the state legislature. Subject-to-appropriation bonds bear the political risk that the legislature may choose to appropriate moneys for other commitments, such as funding pension liabilities. In the Kansas Cease-and-Desist Order, the SEC found:

[U]nlike many states that provide significant legal protections regarding the repayment of their debt, in Kansas the Legislature must annually appropriate money to pay the principal and interest on the debt issued by the K DFA on its behalf. Because of this requirement for annual appropriation, bond holders are at risk that the Legislature may choose, for any reason, to not appropriate funds for debt service over other competing budget demands, such as state services, school funding, or pension obligations.

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193.1. *In re* State of Kansas, SEC Cease-and-Desist Order, Securities Act Release No. 9629 (Aug. 11, 2014).

193.2. *See* section 8:6.2[A].

Subject-to-appropriation bond official statements traditionally contain carefully worded disclosure of appropriation risk, and the message of the SEC in the Kansas Cease-and-Desist Order is that where there is such a large UAAL and low funded ratio as in Kansas, the risk of appropriation disclosure needs to be buttressed with disclosure that the pension funding liability is a significant competitor for the same funds that might be appropriated for debt service. Additionally, the bondholders are unlikely to have a compelling constitutional basis to challenge a legislative decision to pay pension liability before bonded debt liability.

Since the KDFA is an independent instrumentality of the state, it is particularly important to have policies and procedures in place to enable KDFA to access information about KPERS from the system and its funding from state officials. The cease-and-desist order gives considerable attention to the failures of the policies and procedures, and the SEC states that the disclosure failures “resulted from insufficient procedures and poor communication.” New disclosure policies and procedures were implemented prior to a November 2011 offering of bonds, and the SEC observed that in the most recent official statements, there was a separate appendix discussing KPERS and, among other things, its unfunded status.

### **§ 8:6 Disclosure of Legal Issues Related to the Security for Municipal Bonds**

In light of the impact of the 2008 recession on the budgets and finances of state and local governments, a number of issuers of municipal securities have expanded the official statement discussion of the security for debt obligations. The materiality of a more expansive explanation of security increases for state and local governments that are experiencing fiscal distress. Disclosure of material facts related to security in public finance is weighted toward descriptions of law and operative documents. Material information about security should outline the constitutional and statutory law, and, where appropriate, summarize applicable state court decisions that interpret the law. The security provisions of the bond ordinance, resolution, or indenture should be stated, and it may be useful to repeat the language of relevant legal opinions as they relate to security. A number of the salient issues regarding procedural requirements for repayment, including the procedures for raising taxes or revenues should be explained. Procedural disclosure is particularly important because a municipality does not accumulate profits—it balances a budget, and it is important for an investor to be able to evaluate whether the municipality will be able to continue to balance its budget in circumstances of fiscal stress. Substantive limitations on the security for the

bonds, bondholder remedies, and the priority of debt payment in relation to other obligations are likely to be material. Most of these procedural and substantive topics can ordinarily be described by reference to law or operative documents. If the person drafting the disclosure decides to further elucidate the quality of the security by describing actions expected to be taken by officials, that should be done with considerable care, and the disclosure should be either written or reviewed by counsel.

Disclosure of security for municipal bonds has issues that are unique to public finance. The current assets of a business corporation typically relate to the sale of goods, and disclosure in corporate finance gravitates toward indicators of profit or loss. The current assets of a city relate primarily to its tax revenues, usually ad valorem property taxes, and a description of the tax base securing bonds leads to constitutional law, statutory law, bondholder remedies, and the inevitable ambiguity of the applicable law mixed with an ever-present undercurrent of political realities. For good measure, there is also state sovereignty to control the affairs of political subdivisions.

The U.S. Supreme Court acknowledged these issues in a 1942 decision interpreting the application of the Contract Clause of the federal Constitution to the city of Asbury Park, New Jersey, which was in default on the payment of general obligation bonds. Justice Frankfurter, in the majority opinion, wrote:

The principal asset of a municipality is its taxing power and that, unlike the asset of a private corporation, can not be available for distribution. An unsecured municipal security is merely a draft on the good faith of a municipality in exercising its taxing power. The notion that a city has unlimited taxing power is, of course, an illusion. A city cannot be taken over and operated for the benefit of its creditors, nor can its creditors take over the taxing power. Indeed, so far as the federal Constitution is concerned, the taxing power of a municipality is not even within its control—it is wholly subordinate to the unrestrained power of the state over political subdivisions of its own creation.<sup>194</sup>

Justice Frankfurter, writing in the tradition of realism as legal philosophy, continued with a commentary on the political realities behind the bondholder remedy of mandamus:

[T]he practical value of an unsecured claim against the city is inseparable from reliance upon the effectiveness of the city's taxing power. The only remedy for the enforcement of such a

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194. *Faitoute Iron & Steel Co. v. City of Asbury Park, N.J.*, 316 U.S. 502, 509 (1942).



claim is a mandamus to compel the levying of authorized taxes. . . .  
 [Prior experience] shows that the right to enforce claims against  
 the city through mandamus is the empty right to litigate.

. . .

And so we have had the spectacle of taxing officials resigning from  
 office in order to frustrate tax levies through mandamus, and  
 officials running on a platform of willingness to go to jail rather  
 than to enforce a tax levy. . . .<sup>195</sup>

Constitutional, statutory, and political context, as well as the inherent  
 ambiguities of judicial decisions on bondholder remedies, should  
 remind those who are drafting disclosure in the official statement on  
 the security for the bonds to stick closely to factual statements of  
 law, to interpretations of law that are generally accepted in the jurisdic-  
 tion, and to the security provisions of the documents authorizing the  
 issuance of the bonds.

Professor Clayton Gillette delivered a keynote address to a 2012  
 conference of the National Association of Bond Lawyers in which he  
 used *City of Asbury Park* to introduce a different, but related, topic for  
 consideration by lawyers.<sup>196</sup> Gillette used Justice Frankfurter's excu-  
 sion into legal realism to make a point previously made by Gillette  
 in the law review literature—that judicial decisions on bondholder  
 remedies are more likely to establish the relative bargaining power in  
 negotiations between bondholders and residents than to make a final,  
 enforceable determination of the bondholders' rights to full payment  
 of principal and interest.<sup>197</sup> This point serves to emphasize the  
 uncertainty of the outcome of bondholder assertions of remedies. An  
 issuer that is in default, or is under state fiscal emergency oversight,  
 or is acting under Chapter 9 of the Bankruptcy Code is likely to be  
 subject to the vagaries of bargaining, and there is little that is certain  
 for the person drafting statements about expectations in an official  
 statement. Unlike private corporations, municipalities face the uncer-  
 tainties inherent in periodic elections for office and the separation of  
 powers within the government. To the extent information, in addition  
 to descriptions of law and covenants, is warranted, retreat to the  
 language of "investor considerations" or risk factors may, in some cir-  
 cumstances, be necessary.

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195. *Id.* at 509–11 (citations omitted).

196. Gillette, *Bond Attorneys Workshop 2012 Keynote Address*, reprinted in  
 THE BOND LAWYER, vol. 35, no. 1, at 2 (Spring 2013).

197. *See, e.g.*, Gillette, *Bondholders and Financially Stressed Municipalities*, 39  
 FORDHAM URBAN L.J. 639 (2012).

### § 8:6.1 **Disclosure Issues in the Use of the Term “Pledge”**

Each time the term “pledge” is drafted into an official statement, special care should be taken to assure that it is being used accurately. There is not a single meaning to the term, and, like most issues related to disclosure of the security for bonds, the meaning of a pledge in any particular context is driven by state law. This section 8:6.1 will refer to at least five different legal applications of the term “pledge,” and they will be introduced here simply to emphasize the importance of recognizing that there is no one standard meaning when statutes or documents make reference to a pledge.

The meanings of a pledge range from a security interest in personal property to a formal contractual promise or undertaking.<sup>198</sup> Whether there is a security interest or a contractual commitment can be highly significant. At common law, a pledge was part of the law of bailment, and the pledge of personal property in a pawn shop was typical. The debtor borrowed money from the pawnbroker and physically delivered to the pawnbroker, as bailee, possession of the personal property to be held as security. The property was returned to the debtor upon repayment of the loan. If the debtor did not repay the loan, the pawnbroker had the right to sell the property in accordance with the terms of the bailment. Clearly, if the property had not been delivered to the pawnbroker, the pawnbroker would not have been secured, and no pledge would be said to have existed.<sup>199</sup>

The term “pledge” has at least the following usages:

1. *The pledge of revenues securing revenue bonds.* Typically, the trust indenture or bond resolution pledges revenues deposited in the revenue fund and held in the possession of the bond trustee for the benefit of bondholders. This pledge was originally created to be comparable to the secured interest of the pawnbroker. The revenue fund itself, and the bond fund, the bond reserve fund, or other funds may also be pledged, particularly if they are funds in the possession of the trustee. If the right of the trustee to receive future payment of revenues is pledged, or there is a pledge of funds in the possession of the municipal entity, the quality of the pledge will be dependent on the state law that authorizes a pledge of money or a fund not in the possession of the trustee.

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198. BLACK’S LAW DICTIONARY (8th ed. 2004).

199. HENSON, SECURED TRANSACTIONS § 3.1, at 17 (3d ed. 1983).

2. *The pledge of the issuer's full faith and credit.* As discussed below, this pledge is more in the nature of a binding commitment than the creation of a security interest, and, at least under the Bankruptcy Code, is likely to be treated as unsecured debt. An illustrative exception is the Rhode Island statute summarized in section 8:6.2[B]. The Rhode Island statute requires local governments to pledge their full faith and credit to secure general obligation bonds, and then defines the pledge as a first lien on, and a grant of security interest in, ad valorem taxes and general fund revenues. The lien created is intended to constitute a statutory lien under Chapter 9 of the Bankruptcy Code.
3. *A pledge of revenues to secure general obligation bonds.* General obligation bonds often contain a pledge of revenues similar to a pledge of full faith and credit. Like a pledge of full faith and credit, a pledge of revenues may simply be in the nature of a commitment, and, under the Bankruptcy Code, may be treated as unsecured debt. If the revenue pledge is made in a bond ordinance pursuant to statutory authorization to pledge the issuer's revenues (at the discretion of the issuer), the pledge is likely to provide additional security under state law, but, under the Bankruptcy Code, it may be classified as a consensual lien and not a statutory lien. A statutory lien has the benefit of avoiding the automatic stay with the effect that the revenues subject to the lien will continue to flow to the benefited creditors after a Chapter 9 petition is filed. Under section 552(a) of the Bankruptcy Code, a consensual lien does not operate to prevent the automatic stay.
4. *A pledge of "special revenues" to secure general obligation bonds.* This pledge may be enacted by legislation to provide that a general obligation bond has some of the security attributes of a revenue bond. The quality of the pledge will depend on the legislation, and whether the pledge constitutes a pledge of special revenues under sections 902, 922, and 928 of the Bankruptcy Code (to avoid application of the automatic stay) will depend on a bankruptcy court's interpretation of the pledge, and whether it is a pledge under one of the five categories of special revenues in section 902.
5. *A pledge of specified taxes to secure general obligation bonds.* Again, the legislative authorization is important. There may be a pledge of the taxing power, which could be in the nature of a commitment, or there could be a pledge of the taxes as received, which may constitute a security interest, particularly

if the taxes are set aside in a special fund designated for bondholders. The taxes pledged could be within one of the categories of special revenues under section 902 of the Bankruptcy Code (for example, hotel taxes might qualify), with the benefit that the automatic stay would not apply to the taxes that constitute special revenues. Alternatively, the statute may create a “statutory lien” on certain taxes and may command the municipal entity to pledge the taxes to evidence the statutory lien.<sup>200</sup>

Each of these five usages of “pledge” has variations that could affect disclosure, and there are other circumstances in which statutes or documents include the language of a pledge.

The disclosure of a pledge should also be drafted carefully to avoid an implication that the pledge creates a first lien or a priority in payment, unless such a conclusion is warranted by a legal opinion or a clear provision of law. The common law pawnbroker’s possession of property gave the pawnbroker a highly secure position, but the wide ranging modern use of the language of pledges should not be interpreted to mean there is a “perfected security interest” or a first lien or a priority to payment. The opinion of bond counsel will ordinarily address only the taxes from which general obligation bonds are payable and the creation of the pledge securing revenue bonds, but not the priority of debt service payments. The NABL Model Bond Opinion for general obligation bonds<sup>201</sup> contains this statement:

The rights of the owners of the Bonds and the enforceability of the Bonds are limited by bankruptcy, insolvency, reorganization, moratorium, and other similar laws affecting creditors’ rights generally, and by equitable principles, whether considered at law or in equity.<sup>202</sup>

In addition to this statement, the NABL Model Bond Opinion for revenue bonds<sup>203</sup> includes the opinion that:

The Resolution creates a valid lien on the Revenues and other funds pledged by the Resolution for the security of the Bonds on a

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200. A bankruptcy court in the Eastern District of California ruled that a Health Care District’s pledge of ad valorem taxes to secure its general obligation bonds qualified as both a special revenue pledge and a statutory lien under Chapter 9, and therefore was not to be interrupted by reason of the bankruptcy petition. *In re Sierra Kings Health Care Dist.*, Case No. 09-19728 (Bankr. E.D. Cal. Sept. 13, 2010).

201. NABL, MODEL BOND OPINION REPORT (4th ed. 2003).

202. *Id.* at 4.

203. *Id.* at 20.

parity with other bonds (if any) issued or to be issued under the Resolution.<sup>204</sup>

Note that a “valid lien” does not imply a “first lien,” and the phrase “parity with other bonds . . . under the Resolution” is not an opinion that there is a priority of payment in relation to other creditors who are not the holders of bonds under the Resolution. After the statement of general creditors’ rights limitations that is in the general obligation bond opinion, the Model Bond Opinion for revenue bonds expressly states:

We express no opinion [herein] regarding . . . the perfection or priority of the lien on Revenues or other funds created by the Resolution. We note that, unless perfected, the lien on Revenues may not be effective.<sup>205</sup>

The NABL commentary on the revenue bond opinion adds:

In view of the possible complexity of perfection and, especially, priority opinions, the model opinion addresses only the creation of the bond pledge. . . . If perfection opinions are given, it is suggested that they be rendered by the issuer’s other counsel or be included in a supplemental opinion of bond counsel addressed to the underwriter.<sup>206</sup>

### **§ 8:6.2 General Obligation Bonds**

The first sentence of the definition of a general obligation bond in the MSRB’s *Glossary of Municipal Securities Terms*<sup>207</sup> states that a general obligation bond “[t]ypically refers to a bond issued by a state or local government that is payable from general funds of the issuer, although the precise source and priority of payment for general obligation bonds may vary considerably from issuer to issuer depending on applicable state or local law.” In other words, before disclosing the attributes of a general obligation bond in an official statement, the person drafting should consult the applicable law. General obligation debt may be nothing more than unsecured debt. In a bankruptcy proceeding in which Chapter 7 of the Bankruptcy Code applies, section 726 of the Bankruptcy Code treats all unsecured nonpriority claims alike for pro rata distribution of the available estate property. Under Chapter 9 and Chapter 11, the debtor’s approved plan will

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204. *Id.*

205. *Id.* at 21.

206. *Id.* at 23.

207. *See* [www.MSRB.org](http://www.MSRB.org).

determine the priority of unsecured claims, and a Chapter 9 plan is likely to be the product of bargaining in which the case law on bondholders' remedies may simply indicate the relative bargaining power of bondholders.<sup>208</sup>

In most cases, general obligation bonds are supported by the full faith and credit of the issuer, and, accordingly, the MSRB *Glossary* definition goes on to state: "Most general obligation bonds are said to entail the full faith and credit (and in many cases the taxing power) of the issuer, depending on applicable state or local law." Note again, the direction to consult applicable law. General obligation bonds that "entail" the "taxing power" of the issuer, whether or not full faith and credit bonds, vary as to the type of taxing power, and either they may be payable from the issuer's unlimited taxing power, or there may be legal limits on the amount of taxing power that is available to provide revenues for repayment. The third sentence of the MSRB definition points to additional issues: "General obligation bonds issued by local units of government often are payable from (and in some cases solely from) the issuer's ad valorem taxes, while general obligation bonds issued by states often are payable from appropriations made by the state legislature." Parenthetically, it should be recognized that a suit by bondholders to compel a state (or certain state agencies) to levy taxes and pay debt service may be barred by a motion to dismiss on the state's claim of sovereign immunity, as described in chapter 16.

### **[A] What Is Full Faith and Credit?**

A term of art has been applied to describe much of government debt in the more than two hundred years since creditors began to demand that debt be incurred by the organic "state" rather than by the "king," who (in the stark analysis of the world of credit) was nothing more than an individual person. The state has ever since been said to "pledge its full faith and credit." The ambiguity of this term of art is indicative of its having been conceived when it was not altogether clear how the organic state differed from the person of the king, and the United States never adopted European ideas of an organic state, opting instead to delegate certain powers to named institutions of government. The word "faith" is suggestive of the term's having been conceived in a time when religious references had implications of trust. The word "credit" implied that the credit of the body politic was something better than the credit of a mortal king, particularly a mortal king inclined to renege on fulfilling promises.

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208. Gillette, *supra* note 197, at 655.

The well-known meaning of the common law “pledge” in the law of bailments gave rise to the term being attached to a full faith and credit obligation to make the ambiguous words “faith” and “credit” appear more concrete. A “pledge” of “faith” and a “pledge” of “credit” are conceptually troublesome when the law of bailments is taken into account. Although probably used in early modern public finance to suggest something of substance, the pledge of faith and credit realistically was simply a commitment. As shown below, a pledge of full faith and credit can result in state law remedies to enforce the commitments contained in the pledge, but under the Bankruptcy Code, a general obligation bond, even with a pledge of full faith and credit, is unsecured debt, subject to the automatic stay, and susceptible to restructuring pursuant to the plan.<sup>209</sup> For general obligation bonds to have priority under Chapter 9, state law would have to provide a security interest in the form of a statutory lien or a pledge of special revenues. A pledge of full faith and credit, by itself, is not a statutory lien or a pledge of special revenues.<sup>210</sup>

In light of the ambiguities associated with the word “pledge,” a number of commentators avoid the implication that full faith and credit creates some form of a security interest. Thus, one treatise simply sidesteps the word “pledge” by stating that full faith and credit is “a term that implies that the issuer will, in good faith, use any and all available revenue-producing powers to pay the obligation as it becomes due.”<sup>211</sup> A common approach is to replace the term “pledge” with the term “commitment.” Thus, the MSRB *Glossary of Municipal Securities Terms* provides the following definition (emphasis added):

Full Faith and Credit. A term normally used in connection with general obligation bonds to express the *commitment* of the issuer to repay the bonds from all legally available funds, including a *good faith commitment* to use its legal powers to raise revenues to pay the bonds, although the precise nature of such *commitment* may vary considerably from issuer to issuer depending on applicable state or local law. However, some issuers may issue full faith and credit bonds without stating that such bonds are general obligations. In some cases, such full faith and credit bonds may be indistinguishable from typical general obligation bonds, while other full faith and credit bonds may be expressly distinguishable

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209. *In re Sanitary & Improvement Dist. No. 7*, 98 B.R. 970, 973–74 (Bankr. D. Neb. 1987); Kordana, *Tax Increases in Municipal Bankruptcies*, 83 VA. L. REV. 1035, 1048 (1997).

210. Spiotto, *The Myth and Reality of State and Local Governments Debt Financing in the U.S.A. in Times of Financial Emergency*, Chapman and Cutler LLP 36 (July 25, 2011).

211. AMDURSKY & GILLETTE, *MUNICIPAL DEBT FINANCE LAW: THEORY AND PRACTICE* 26 (1992).

from general obligation bonds with potentially differing sources and priority of payments, depending on applicable state or local law.

The *Glossary* definition makes clear that full faith and credit implies two distinct commitments: (1) a commitment of all legally available funds as credit for repayment, and (2) a good faith commitment to take action to use the issuer's legal powers to raise revenues to make the payment. The New York Court of Appeals has held that "[a] pledge of the city's faith and credit is both a commitment to pay and a commitment of the city's revenue generating powers to produce the funds to pay."<sup>212</sup> In its order confirming the Jefferson County, Alabama, plan of adjustment under Chapter 9 of the Bankruptcy Code, the bankruptcy court made a similar interpretation of a pledge to mean a commitment. The court described the general obligation warrants as "a general obligation of the County in support of which the County irrevocably pledged its full faith and credit." The next sentence interpreted the pledge: "This pledge is a commitment to pay and a commitment of the County's revenue-generating powers to produce the funds necessary to pay the principal and interest on the [general obligation] Warrants."<sup>213</sup> Since a full faith and credit pledge has these two commitments, the pledge is more than a mere promise to pay, and may properly be described in the official statement as "security" for the bonds, even if the jurisdiction does not create a statutory lien.

**[A][1] Specific Items for Disclosure Related to Full Faith and Credit Bonds**

The MSRB *Glossary* definition of full faith and credit described above provides a useful template to guide disclosure related to a full faith and credit general obligation bond. As noted, the *Glossary* divides the commitment into two components: (1) a commitment of all legally available funds as credit for repayment, and (2) a good faith commitment to take action to use the issuer's legal powers to raise revenues to make the payment. The disclosure should respond to the substantive meaning of "all legally available funds," and the procedural steps that constitute the issuer's "use [of] its legal powers to raise revenues."

Subsection [D] below describes the substantive topics that are likely to arise in disclosure of the security for general obligation bonds. These

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212. Flushing Nat'l Bank v. Mun. Assistance Corp., 40 N.Y.2d 731 (1976).

213. *In re* Jefferson County, Alabama, Findings of Fact, Conclusions of Law, and Order Confirming the Chapter 9 Plan of Adjustment for Jefferson County, Alabama (U.S. Bankr. Ct. N.D. Ala., Nov. 6, 2013), Findings of Fact, ¶ N. 1.(a)(iii).



topics include the specific taxes, revenues, or funds that are available and dedicated to pay the principal of and interest on the bonds. If the general obligation bonds are supported by a full faith and credit commitment, the relevant issue may be whether *all* taxes, revenues, and fund balances are available and dedicated to pay debt service. If not all taxes, revenues, and fund balances are available, the discussion will turn to which are available and dedicated, and whether there are preconditions for making them available.<sup>214</sup> Logically, the next topic is whether the identified sources of payment are set aside in a special fund, whether moneys in the fund are available only for debt service, or whether the identified sources of payment are otherwise made subject to a security interest for the benefit of the bondholders. The objective should be to equip the investor with sufficient information to enable the investor to turn to the financial statements or economic data and analyze the actual numbers related to the security for the bonds.

In addition to the NFMA's 2014 publication of its White Paper,<sup>215</sup> in 2014 NABL released a paper to educate its members and other public finance market participants about various issues related to general obligation bonds.<sup>216</sup> In this General Obligation Bonds Paper, NABL also organized its discussion of the security behind general obligation bonds into substantive and procedural issues. As summarized in subsection [E] below, procedural matters highlighted by NABL include procedures in connection with the budgetary process, procedures for imposing or increasing taxes, procedures for the collection, custody, and appropriation of funds, and procedures for the application of amounts to the payment of debt service, and whether any of these steps are mandated by statute, are discretionary, are conditional, or require action by another governmental entity.<sup>217</sup> If the general obligation bonds are supported by a full faith and credit commitment, disclosure is likely to show the effect of the full faith and credit commitment on these procedures, and whether procedural requirements are lessened or removed or procedural requirements for the payment of full faith and credit bonds have priority over other types of debt or contractual obligations.

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214. This distinction between disclosure for general obligation bonds and full faith and credit general obligation bonds is highlighted in a draft white paper of the National Federation of Municipal Analysts (NFMA) published for comment in 2014. NFMA, *White Paper on Best Municipal Bond Issuance and Disclosure Practices* (draft of Jan. 14, 2014) [hereinafter *NFMA White Paper*].

215. *Id.*

216. NABL, *General Obligation Bonds—An Overview; State Law, Bankruptcy and Disclosure Considerations* (draft of Apr. 22, 2014) [hereinafter *NABL General Obligation Bonds Paper*].

217. NABL *General Obligation Bonds Paper* 5.

**[A][2] Disclosures Based on Constitutional Law in New York**

Understandably, when an issuer is directed, or authorized, by the state constitution or a statute to “secure” its bonds with a pledge of the issuer’s full faith and credit, there may be difficult issues of interpretation for a court if the issuer is in default on debt service payments, and the rights of bondholders are pitted against the rights of residents who claim they are owed municipal services. Does a pledge of full faith and credit mean something more than the fiduciary duty that is owed to residents? Is an employee who is owed salary in the form of a pension payment for work previously performed conceptually distinguishable from the bondholder who has been given a pledge of full faith and credit?<sup>218</sup> In each case, there is an obligation of trust. The same difficulty facing a judge faces the drafter of disclosure in writing an official statement for an issuer that is financially distressed, when investors and analysts are demanding information about the implications of a full faith and credit pledge if a default were to occur in the future. The constant reminder when drafting disclosure should be that the securities law obligation to disclose material facts does not require (actually, does not allow) conjecture about the future outcome of uncertain events.

A person drafting disclosure in a state where the meaning of full faith and credit has been adjudicated is at least in a position to state what the courts have decided, if the circumstances suggest that such disclosure would add material information. Two cases illustrate a range of possible interpretive responses: a 1943 Florida case, *State v. City of Lakeland*,<sup>219</sup> and a 1976 New York case, *Flushing National Bank v. Municipal Assistance Corp.*<sup>220</sup> *City of Lakeland* can be said to describe full faith and credit as a good faith commitment. The majority opinion in *Flushing National Bank* read the City of New York’s pledge of full faith and credit in the light of mandatory provisions of the New York Constitution, and found that the constitutional backdrop necessitated a more pronounced “security” meaning. *City of Lakeland* was based on a proposed refunding bond issue, which contained a pledge that differed from the pledge on the bonds being refunded. Florida law did not allow the pledge on the refunding bonds to be stronger than the pledge on the underlying bonds without voter approval. The court, therefore, reviewed the pledge of full faith and credit on the underlying bonds, and determined that the pledge of full faith and credit was not equivalent to the lien that the issuer

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218. The competing claims of bondholders and pension beneficiaries are discussed in section 8:5.3[D].

219. *State v. City of Lakeland*, 154 Fla. 137, 16 So. 2d 924 (1943).

220. *Flushing Nat’l Bank v. Mun. Assistance Corp.*, 40 N.Y.2d 731 (1976).

attempted to create to secure the refunding bonds. Describing the full faith and credit pledge of the underlying bonds, the court stated:

[S]uch pledge does not create a specific lien on any particular property. It does no more, in legal effect, than express an undertaking by the City to be irrevocably obligated, in good faith, to use such of its resources and taxing power as may be authorized or required by law for the full and prompt payment of the principal and interest of the obligation as it becomes due under its terms.<sup>221</sup>

The obligation was thus contractual in nature, albeit a commitment to act in good faith to take steps to effect the payment.

The New York Court of Appeals concluded that a pledge of full faith and credit under the New York Constitution was more than an ordinary contract. The case arose during the New York City fiscal crisis, and the court had before it the constitutionality of the New York City Emergency Moratorium Act, which, by its terms, prevented the holders of short-term notes, who refused to exchange the notes for longer-term bonds issued by the Municipal Assistance Corporation, from bringing an action to enforce payment on the notes for three years. The notes contained a pledge of the City's full faith and credit. The court reasoned that the New York constitutional structure for local finance prevented it from reaching a conclusion that the City could, in good faith, stop short of exhausting its taxing power for debt service payments even when applying its taxing power to debt service could be detrimental to the general welfare in a fiscal emergency. First, the majority opinion noted that Article VIII, section 2 of the New York Constitution did not allow a city to contract indebtedness unless it had "pledged its faith and credit for the payment of principal thereof and the interest thereon," and the court concluded that the constitutional "requirement" had implications. "The constitutional requirement of a pledge of a city's faith and credit is not satisfied merely by engraving a statement of the pledge in the text of the obligation." Such a construction would reduce the pledge to a moral obligation.

The constitutional prescription of a pledge of faith and credit is designed, among other things, to protect rights vulnerable in the event of difficult economic circumstances. Thus, it is destructive of the constitutional purpose for the Legislature to enact a measure aimed at denying that very protection on the ground that government confronts the difficulties which, in the first instance, were envisioned.<sup>222</sup>

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221. *City of Lakeland*, 154 Fla. at 139.

222. *Flushing Nat'l Bank*, 40 N.Y.2d at 736 (citation omitted).

Second, the court referred to a part of Article VIII, section 2 that limited real estate taxes to 2.5% of the average full valuation of taxable real estate, but made an exception if it were necessary to exceed the ceiling to pay debt service. Third, the court noted the fourth paragraph of Article VIII, section 2, which provided that, in the event tax or revenue anticipation notes are not paid within five years of the date of issuance, “a sufficient sum shall be set apart from the first revenues thereafter received and shall be applied to such purposes.” The majority opinion stated: “Actually, the presence of the specific remedy against a defaulting municipality, beyond the generality of the faith and credit clause, is conclusive that the Constitution permits no escape for the municipality from performing its obligations.”

The meaning of the full faith and credit pledge in other states may have less of the constitutional imperative that was found in the *Flushing National Bank* majority opinion. The dissent in *Flushing National Bank*, like the majority in *City of Lakeland*, focused on “good faith.” The dissent reasoned that the pledge “requires no more than that the city make a good faith effort to use its resources, credit and powers to pay its indebtedness.” In states where this approach is controlling, disclosure would vary from a New York official statement that is able to quote the majority opinion in *Flushing National Bank*. In fact, in New York, much of the information that is necessary to describe the substantive component of a general obligation bond in an official statement can be derived from the state’s constitutional law.

The New York Constitution requires cities, counties, and school districts to pledge their faith and credit for the payment of the principal of, and interest on, their general obligation bonds, and the constitutional provisions related to general obligation bonds of cities, counties, and school districts are the same, as interpreted by *Flushing National Bank* and other related New York Court of Appeals decisions. Accordingly, cities, counties, and school districts throughout the state have developed standard language for disclosure of the “nature of the obligation” (New York Standardized Disclosure) which provides investors with information describing the implications of a faith and credit obligation.<sup>222.1</sup> For purposes of this summary, an official statement of the City of Elmira will be referenced.<sup>223</sup> The New York Standardized Disclosure describes the substance of a faith and credit

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222.1. For examples of official statements that used the New York Standardized Disclosure, see \$25,979,035 City of Ithaca, Tompkins County, New York Official Statement (Feb. 19, 2014); \$34,800,000 County of Onondaga, New York Official Statement (June 12, 2014); \$26,631,539 City School District of the City of Schenectady, Schenectady County, New York Official Statement (June 2, 2014).

223. \$2,543,000 City of Elmira, Chumung County, New York Official Statement (Mar. 27, 2014).

general obligation bond at the beginning of the official statement. The section cites the fact that the general obligation bonds will be secured by a pledge of the faith and credit of the issuer. The following sentence introduces the meaning of the pledge: "For the payment of such principal and interest, the City has power and statutory authorization to levy ad valorem taxes on all real property within the City subject to such taxation by the City, subject to the applicable statutory limitations." The official statement next introduces the "Tax Levy Limitation Law" and references a fuller description of the law later in the official statement. Other sections on tax levies and collections, budgetary procedures, and related topics provide data on historical collections of taxes on the property subject to the levy, and the procedures by which the taxes collected are applied to debt service. After the references, the section on "Nature of Obligation" continues with a discussion of the meaning of a pledge of faith and credit and the constitutional override of tax limitation laws.

The New York Standardized Disclosure cites language from *Flushing National Bank*, quoted above, to the effect that the pledge is both a commitment to pay and a commitment to use the city's revenue-generating power to produce sufficient funds to pay principal and interest. The next paragraph informs investors of the accepted interpretation of the case, and other cases, in language that provides information that is material to investors, but is not conjectural: "The pledge has generally been understood as a promise to levy property taxes without limitation as to rate or amount to the extent necessary to cover debt service [due to] language in . . . the Constitution which provides an exclusion for debt service from Constitutional limitations on the amount of a real property tax levy . . ." *Quirk v. Municipal Assistance Corp.*<sup>224</sup> is quoted for its holding that bondholders have a "first lien" on revenues, although they do not have a right to any particular revenues. The disclosure informs the investor that under state constitutional law, the issuer is required to raise taxes or revenues to pay debt service, and that bondholders have a priority position. The disclosure thus summarizes the substantive meaning of a faith and credit pledge, and the existence of the case law allows the drafters of the disclosure to describe the security by closely stating the constitutional law.

### **[B] Statutory Liens; Rhode Island**

If a state legislature decides to prevent a full faith and credit pledge from losing its luster in the event a political subdivision files for protection under Chapter 9 of the Bankruptcy Code, it can enact

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224. *Quirk v. Mun. Assistance Corp.*, 41 N.Y.2d 644 (1977).

legislation that will secure general obligation bonds with a statutory lien or provide a special revenues pledge that is similar to the pledge of a source of funds securing revenue bonds. While each case is different, a statutory lien should allow a bankruptcy judge to conclude that payment of principal and interest can continue after the petition is filed. A statutory lien is created automatically by statute and not by agreement of the parties. The financial difficulties of Central Falls, Rhode Island, led the state legislature to create a statutory lien to protect the credit of Central Falls and other local governments issuing general obligation indebtedness.

In 2010, Central Falls asked the Rhode Island legislature to permit it to file a petition for Chapter 9 bankruptcy. When the legislature did not act, Central Falls asked a state judge to appoint a receiver, and that request was granted. The legislature then passed a law prohibiting cities and towns from seeking judicial receivers on their own motion, and passed legislation creating a system for state-appointed receivers. The state receiver took over from the judicially appointed receiver. Central Falls challenged the constitutionality of the state action, but the Rhode Island Supreme Court upheld the state receiver law.<sup>225</sup> Separately, the legislature enacted, and the governor, on July 2, 2011, signed into law, a statute that mandated municipalities to guarantee payment of their general obligation bonds and notes, and that imposed a statutory first lien in favor of lenders and holders on property taxes and general revenues.<sup>226</sup> The statute begins with provisions that the power of each city and town to pay its general obligation bonds and notes is to be unlimited, and orders each city and town to levy ad valorem taxes, without limitation of rate or amount, to pay principal and interest. These requirements are followed by provisions for security:

The faith and credit, ad valorem taxes, and general fund revenues . . . shall be pledged for the payment of principal of, premium and interest on, all general obligation bonds and notes . . . and shall constitute a first lien on such ad valorem taxes and general fund revenues.<sup>227</sup>

The statute adds a lengthy section providing expressions of the legislature's intended statutory construction and interpretation. For example:

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225. Moreau v. Flanders, 15 A.3d 565 (R.I. 2011).

226. R.I. GEN. LAWS § 45-12-1.

227. R.I. GEN. LAWS § 45-12-1(a).

- (1) The pledge of ad valorem taxes and general fund revenues . . . is valid and binding, and deemed continuously perfected from the time the bonds or notes . . . are issued;
- (2) No filing need be made under the uniform commercial code or otherwise to perfect the first lien on ad valorem taxes or general fund revenues;
- (3) The pledge of ad valorem taxes and general fund revenues is subject to the lien of the pledge without delivery or segregation . . . ;
- (4) The pledge shall be a statutory lien effective by operation of law . . . .<sup>228</sup>

### **[C] Unlimited-Tax and Limited-Tax General Obligation Bonds**

In addition to the nature of the security supporting general obligation bonds, disclosure must necessarily provide information describing the sources of payment for debt service and legal limitations on the availability of those sources. A number of categories are in common usage for distinguishing general obligation bonds, and the categories imply disclosure issues to be addressed. Since local governments rely heavily on ad valorem taxes, an unlimited-tax general obligation bond usually means that the bonds are supported by the issuer's ad valorem taxing power that is not limited with respect to either the rate of the tax or the amount of the levy. A limited-tax general obligation bond indicates that the issuer has a limited ability to levy ad valorem taxes in order to pay debt service. There may be an absolute cap on the millage rate or a limit on the total dollar amount either in a given year or because a debt ceiling is looming. Since the issuer lacks flexibility to avoid legal constraints, disclosure will necessarily require considerable attention to the effects of the limits and the competing budgetary claims for available amounts.

Certain general obligation bonds may be payable from sources other than ad valorem tax levies and still be referred to as general obligation bonds. Some states do not permit a pledge of ad valorem taxes, and the bonds are payable from amounts in the general fund without specification of source. A more accurate description of the bonds might be "general fund obligations" to avoid the assumption that ad valorem taxing power stands behind any municipal general obligation bonds. A general fund obligation can have a pledge of full faith and credit, but there should be disclosure of available resources and the inability of

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228. R.I. GEN. LAWS § 45-12-1(b).

the issuer in good faith to levy ad valorem taxes to pay debt service, if that limitation applies.

### **[D] Substantive Issues for Disclosure**

The NABL General Obligation Bonds Paper conveniently divides the relevant disclosure issues into those that are substantive and those that are procedural, following the two components in the definition of a full faith and credit commitment. Substantive topics include the sources of repayment and whether the sources are protected from being diverted to uses other than the payment of debt service on bonds. One objective in outlining the disclosure is to provide potential investors with sufficient, but succinctly and clearly stated, information for them to be able to turn (reasonably quickly) to the financial statements and economic data in order to analyze the numbers without being bogged down in weighty, unnecessary dissertations on security. For example, a bankruptcy lawyer's approach to disclosure might be to brief the sources of payment to determine whether there are statutory provisions that give the taxes or revenues the characteristics that qualify for statutory lien or special revenue status under Chapter 9. A lengthy analysis of bankruptcy law is likely to be wholly immaterial if (1) the issuer does not qualify to petition for Chapter 9 relief; (2) the financial condition of the issuer makes bankruptcy highly improbable; (3) the state's constitutional and statutory structure for securing the bonds and procedures for collecting taxes or revenues are adequate; or (4) state oversight controls would be put into effect before any Chapter 9 petition could be initiated. One difficulty in attempting to summarize bankruptcy court opinions to describe the security for a general obligation bond is that the opinions of bankruptcy courts are not binding in other jurisdictions. However, a brief statement indicating whether the issuer is qualified under state law to file a Chapter 9 petition is becoming increasingly common, and in some cases it may be important to discuss whether the issuer is a "municipality" within the meaning of Chapter 9.

The NFMA White Paper lists twenty-seven topics that it recommends be included in the security section for general obligation bonds. Like an underwriter's due diligence checklist, the NFMA's list is useful for the person drafting disclosure to help organize the presentation, but material disclosure should be tailored to the issuer, and the investor should not be overburdened with a lawyer's way of writing an "if this, but if that" type of argument. A comparison of the NFMA list and the NABL General Obligation Bonds Paper shows that both would include in the substantive portion of the disclosure of security: (1) the specific taxes, revenues, or funds that are dedicated to pay general obligation debt service; (2) whether raising taxes or generating revenues to pay debt service is subject to any state or local legal limits;



(3) whether taxes or revenues required for debt service are placed in a special fund; and (4) whether there are mechanisms to intercept pledged revenues or taxes before they are diverted to purposes other than debt service. On the topic of custody and segregation of funds, NABL provides the following summary:

An issuer may be able to or required to segregate or earmark certain funds for payment of debt service under state law. To understand whether an issuer has effectively segregated or earmarked funds for payment of debt service, it's important to understand whether tax collections or other amounts are subject to segregated custody and control, the timing when any segregation occurs, and whether the taxes are levied, collected or held by (or diverted to) a different government entity or third-party custodial agent, perhaps subject to a deposit account control agreement in favor of bondholders . . . .<sup>229</sup>

### **[E] Procedural Issues for Disclosure**

The official statement is likely to describe the routine steps taken in the annual fiscal cycle for the flow of tax receipts and revenues through the budget process to the payment of debt service. The legal procedures required of, or available to, an issuer or the state in the event there is a shortfall in the collection of taxes or revenues will probably be material, and, if there is a possibility that these procedures may be ineffective, the next logical topic of information in the official statement would be bondholder remedies. The NFMA White Paper identifies a number of topics for disclosure to address a possible shortfall in tax receipts or revenues, including (1) the steps necessary for the issuer to increase taxes; (2) whether new or additional voter or other approval is needed to generate the requisite taxes, revenues, or funds; (3) whether the issuer has autonomous authorization to raise tax rates or revenues for repayment of debt service; and (4) whether there are material legal or practical limitations or restrictions on increasing taxes or revenues.

The NABL General Obligation Bonds Paper emphasizes the importance of procedural courses of action and alternatives for the issuer as a framework for understanding bondholder remedies:

To understand the applicability and practical availability of potential remedies, it is important to understand each procedural step an issuer takes in connection with budgeting, imposing or increasing taxes, collection, custody and appropriation of funds, and applying amounts to the payment of debt service, and whether any

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229. NABL, General Obligation Bonds Paper 6.

of these steps is specifically required by statute, is discretionary or conditional, or involves action by another governmental entity. It is also important to understand the timing of each step in relation to the timing of the payment of debt service.<sup>230</sup>

Procedural disclosure can lead naturally to disclosure of bondholder remedies. If an action to be taken by an official to raise or protect taxes and revenues for the benefit of bondholders is “ministerial,” the state’s remedy of mandamus may be effective, but if the official is placed in a position of having to exercise discretion, a court may not intervene with mandamus. There are fiscal problems that may suggest that the appointment of a receiver is necessary to protect creditors, and the state’s procedures for the appointment of a receiver can be described. Similarly, the circumstances in which a state oversight board could be appointed, and procedural conditions for state oversight, may be material in circumstances of fiscal stress.

### **§ 8:6.3 Revenue Bonds**

In their usual form, revenue bonds are payable solely from a limited revenue source. The revenues are derived from a project or program that has been financed with the proceeds of bonds, such as tolls collected at a bridge, charges to customers for electricity generated by a power plant, mortgage payments by homeowners in a single-family-housing program, or loan repayments made by a hospital that has been financed by the issuance of health facility bonds. The primary features of revenue bonds and a comparison of revenue bonds to general obligation bonds are detailed in section 1:6.2. The security for revenue bonds is usually limited to the funds derived from the revenue source, and, therefore, the security interest in the funds is central to disclosure. Section 1:6.2 summarizes a number of topics for disclosure. Here, the emphasis is on state law security for bondholders and bondholder security under the Bankruptcy Code.

#### **[A] Pledge of, or Security Interest in, Revenues**

At common law, a pledge was made effective by possession of the collateral. In order to grant bondholders a pledge of the right to receive future revenues, which are not in the possession of the trustee, the statute authorizing the issuance of revenue bonds may provide that a pledge of the right to receive revenues in the future is a valid and enforceable pledge. Section 1:6.2 describes a statute that (1) creates a statutory pledge of an issuer’s revenues and rights to receive future revenues; (2) makes the pledge valid and binding immediately from the time the pledge is made; and (3) provides that the lien of the pledge

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230. *Id.* at 5.

attaches without any physical delivery or further act by the issuer or the trustee acting under the indenture.

One reason bond lawyers attempt to have state legislators insert the pledge provisions in special legislation tailored to an issuer is to have the specific language of a statute control the security interest benefiting bondholders. Without legislation designed for the unique features of public finance, it may be necessary to resort to general law for the creation of security interests. The Uniform Commercial Code (UCC) was revised in 1998 to provide that the creation, perfection, priority, and enforcement of security interests granted by municipal entities are governed by Article 9 of the UCC. An Article 9 security interest requires counsel to determine that the authorizing documents adequately describe the pledged property and that the municipal entity has rights to the pledged property sufficient for a security interest to attach. The Article 9 provisions on perfection and priority are complicated because the security for revenue bonds does not easily fit the Article 9 categories of collateral, and it may be difficult to determine whether the filing of a financing statement will effectively provide security in rights to collect revenues. UCC § 9-109(c)(2) provides that Article 9 applies unless another statute of the state expressly governs the creation, perfection, priority, or enforcement of a security interest created by the state or a governmental unit of the state. Special legislation designed for the issuer is thus a viable option. In addition, although all the states have enacted the 1998 revisions, more than half the states have enacted nonconforming amendments to exclude security interests created by either the state or its governmental units from the scope of Article 9. In these states, an Article 9 security interest is not an option. For all of these reasons, the creation and effect of a pledge of revenues and the disclosure of the security interest are made considerably easier by the enactment of special legislation governing the revenue bonds.<sup>231</sup>

The security for the holders of revenue bonds may also be affected by competing claims of the holders of general obligation bonds, who may have a full faith and credit pledge of taxes or revenues. In the case of a state authority, a constitutional issue that may arise is whether the revenues flowing to the authority are revenues of the state that must be initially deposited in the general fund of the state and made subject to appropriation by the state legislature. The constitutional issue is whether a direct payment of the revenues to the authority for deposit in a fund held by a trustee for the benefit of revenue bondholders, which is subject to a pledge for the revenue bondholders, is a violation of the appropriation requirements of the constitution. If revenues are first deposited in the state's general fund, they may be exposed to the

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231. NABL, MODEL BOND OPINION REPORT 23 (4th ed. 2003).

priority claim of general obligation bondholders who have a pledge of full faith and credit. Or, if the revenues are deposited with the trustee holding the revenues for the benefit of revenue bondholders in violation of state law, the revenues may be subject to “claw-back” rights of the holders of general obligation bonds.

In most cases, legislation creating an authority and providing that specified revenues are to be deposited directly with an indenture trustee will be drafted to conform to constitutional standards of the state. For example, the New Jersey legislature created the New Jersey Sports and Exposition Authority, and gave it power to issue revenue bonds secured by the proceeds of pari-mutuel wagering on horse races. A percentage of the wagering proceeds was paid to the state for deposit in the general fund, and a percentage was paid to the Authority for deposit with the trustee. The New Jersey Supreme Court held in 1972 that, as to the revenues diverted to the Authority, there was no violation of the appropriations clause of the state constitution, because the constitution did not mandate that all sources of state revenues be deposited in the general fund; that the Authority was an instrumentality of government performing a public purpose; that the Authority’s debt did not create any state debt; and that the Authority was not dependent on appropriations from the state.<sup>232</sup> If bond counsel is satisfied that its opinion concluding that the statute and authorizing documents create the valid and binding pledge that they purport to create meets the firm’s standards for an unqualified opinion on the matter, there should be no need for a disclosure in the official statement, but if the issue is not free from doubt and leads to a reasoned opinion, it may be decided that a risk factor should be added to the disclosure.

## **[B] Bankruptcy Code**

### **[B][1] Right of an Issuer to File a Chapter 9 Petition**

Chapter 9 of the Bankruptcy Code has sections that protect the interests of revenue bondholders to an uninterrupted flow of revenues for the payment of debt service, but the issuer must be entitled to file a petition under Chapter 9, and the issuer may itself prefer Chapter 11 to Chapter 9. The first condition for filing under Chapter 9 is that the petitioner is a “municipality” within the meaning of section 901(40). There, a municipality is defined as a “political subdivision or public agency or instrumentality of a State.” The Bankruptcy Code provides

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232. N.J. Sports & Exposition Auth. v. McCrane, 292 A.2d 545, 553 (N.J. 1972).

that only a “person” that may be a debtor under Chapter 7 may be a Chapter 11 debtor; the definition of a person in section 101(41) generally excludes a “governmental unit”; and section 101(27) defines a governmental unit to include a municipality. Thus, a municipality cannot file under Chapter 11, and, conversely, to file under Chapter 9, the petitioner must be a municipality. The tension between a Chapter 9 case and a Chapter 11 case turns, in part, on whether the petitioner is a municipality.

The bankruptcy court proceedings of the Las Vegas Monorail Company (LVMC) in 2010 are frequently cited in connection with the court’s decision that LVMC was not a municipality and, therefore, belonged under Chapter 11 rather than Chapter 9.<sup>233</sup> The Las Vegas monorail is 3.9 miles in length and runs behind the hotels on the east side of the Las Vegas Strip. The system was financed with the proceeds of tax-exempt industrial development bonds issued by the Director of the Nevada Department of Business and Industry under an indenture of trust and secured by a financing agreement between the Director and LVMC. Like other conduit financings, the bonds were secured by the financing agreement, and the state had no obligation on the debt. The first series of bonds was further secured with bond insurance issued by Ambac Assurance Corp. LVMC filed under Chapter 11; Ambac wanted the case under Chapter 9 to maintain the flow of revenues to pay debt service. LVMC was formed as a nonprofit corporation, and, in support of the tax-exempt status of the bonds, LVMC signed a Tax Certificate expressly stating that LVMC “is an instrumentality of the State of Nevada . . . controlled by the Governor of the State of Nevada.”<sup>234</sup> As discussed in section 2:11, there are securities law circumstances in which a nonprofit corporation can be integrally related to a local government and capable of issuing section 3(a)(2) exempt securities as a part of the government, or by or on behalf of a government.

The bankruptcy court held that LVMC was not a municipality, because it was not a political subdivision, a state agency, or an instrumentality of the state. The court did recognize that authorities that issue revenue bonds are Chapter 9 municipalities, citing the language of the House Report accompanying amendments in 1946:

The existing act does not adequately cover what [are] known as revenue bonds . . . H.R. 6682 amends the existing statute so as to make it applicable to any type of revenue bond issued by a city,

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233. *In re Las Vegas Monorail Co.*, 429 B.R. 770 (Nev. 2010).

234. *Id.* at 774.

town, county, and so forth, and also to make the act applicable to “authorities.”<sup>235</sup>

The LVMC bankruptcy court cited Congressional history in 1977 and 1988 to show that Congress recognized the difference between the issuer of revenue bonds and the conduit borrowers in the case of industrial development bonds. For example, an educational facilities authority is likely to be a Chapter 9 municipality, but the nonprofit university that is the obligated person will not, in most cases, be a municipality. After reviewing other bankruptcy court cases, the opinion concluded that the definition of municipality for purposes of the Bankruptcy Code had three indicia: if there are “traditional governmental powers,” the entity may be a political subdivision or a state agency, but, lacking these, “public purposes” and “state control” can also be indicative of an instrumentality of a state:

The examination of the history of the Bankruptcy Code’s use of municipality and instrumentality show three distinct threads. The first thread focuses on whether the entity has any of the powers typically associated with sovereignty, such as eminent domain, the taxing power or sovereign immunity. If those powers are absent or only weakly present, then courts examine whether the entity has a public purpose. If so, the level of control exerted by the State (or its agreed agents) on the entity’s activities in furtherance of that purpose is relevant; the more control over day-to-day activities, the more likely the entity is an instrumentality under Section 101(40).<sup>236</sup>

If there is doubt about an issuer’s status as a Chapter 9 municipality, a risk factor or other disclosure may be appropriate. It should also be recognized that while state law cannot expand the meaning of a Chapter 9 municipality, it can narrow the types of municipalities that are authorized to file under Chapter 9. Public agencies and instrumentalities of the state may be broad enough to include any entity controlled by the state that raises taxes, user fees, or other revenues to provide public services and projects, or to finance state-sponsored programs. Chapter 9 petitioners have included school districts, hospitals, sanitary districts, irrigation districts, public utility boards, public improvement districts, and bridge or highway authorities. States can limit or place procedural restrictions on the types of municipalities entitled to file under Chapter 9, and these limitations or procedural restrictions may be material disclosure.<sup>237</sup>

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235. *Id.* at 779 (citing H.R. REP. NO. 2246, 79TH CONG., 2D SESS. 2-3 (1946)).

236. *Id.* at 788.

237. Benvenuto & Witalec, *State Law Authorization for a Chapter 9 Filing*, in CHAPTER 9 BANKRUPTCY STRATEGIES 35, 39–40 (2011).

Section 109(c)(1) of the Bankruptcy Code requires that to be a debtor under Chapter 9, the entity must be a municipality, and section 109(c)(2) requires that the entity must be specifically authorized, in its capacity as a municipality or by name, to be a Chapter 9 debtor under state law, or by a governmental officer or organization empowered by state law to authorize such entity to be a debtor under Chapter 9. The states have approached Chapter 9 authorization differently. Twelve states have granted statutory authorization to their municipalities. Other states have limited authorizations or have placed conditions on filing. Twenty-one states are either unclear cases or have not given specific authorization.<sup>238</sup> Whether the issuer has been specifically authorized under state law to file under Chapter 9 is frequently disclosed in an official statement, along with any conditions or related matters that are relevant.

### **[B][2] Special Revenues**

In addition to the state law issues related to the pledge of revenues, an issuer of revenue bonds may decide that disclosure in an official statement should provide information on the rights of bondholders to have the flow of revenues established in the indenture of trust continue in the event the issuer files under Chapter 9. Prior to Bankruptcy Code amendments in 1988, counsel generally concluded that section 552(a) would be applied to a municipal debtor the same as a commercial debtor, that is, “property of the estate of the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.” In short, a pledge of revenues would not survive the filing of the petition.

Section 928 was added to the Bankruptcy Code by amendments in 1988<sup>239</sup> to remove the uncertainty created by section 552(a) for investors in municipal revenue bonds. Section 928 provides:

(a) Notwithstanding section 552(a) of this title and subject to section (b) of this section, special revenues acquired by the debtor after the commencement of the case shall remain subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.

(b) Any such lien on special revenues, other than municipal betterment assessments, derived from a project or system shall

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238. CHAPMAN & CUTLER, *MUNICIPALITIES IN DISTRESS? HOW STATES AND INVESTORS DEAL WITH LOCAL GOVERNMENT FINANCIAL EMERGENCIES* 50–52 (2012).

239. An Act to Amend the Bankruptcy Law to Provide for Special Revenue Bonds, and for Other Purposes, Pub. L. No. 100-597, 102 Stat. 3028 (1988).

be subject to the operating expenses of such project or system, as the case may be.<sup>240</sup>

The purpose of section 928 is to assure that the holders of municipal revenue bonds are entitled to receive the revenues pledged to them without any interference and on a timely basis, in accordance with the authorizing statute and documents, regardless of the issuer operating under Chapter 9. There are five categories of special revenues in the section 902(2) definition of special revenues, and, importantly, the 1988 House Report provides illustrations for each category. The statutory categories are:

- (A) receipts derived from the ownership, operation, or disposition of projects or systems of the debtor that are primarily used or intended to be used to provide transportation, utility, or other services, including the proceeds of borrowings to finance the projects or systems;
- (B) special excise taxes imposed on particular activities or transactions;
- (C) incremental tax receipts from the benefited area in the case of tax-increment financing;
- (D) other revenues and receipts derived from the functions of the debtor, whether or not the debtor has other functions; or
- (E) taxes specifically levied to finance one or more projects or systems, excluding receipts from general property, sales, or income taxes (other than tax-increment financing) levied to finance the general purposes of the debtor.<sup>241</sup>

The House Report illustrations of each of the five respective categories are as follows:<sup>242</sup>

- 1. receipts from the operation of water, sewage, waste, or electric systems;
- 2. excise taxes on hotel or motel rooms, or an excise tax on the sale of alcoholic beverages, but a general sales tax, which is not imposed on particular activities or transactions, would not apply;
- 3. the amount of increased property taxes attributed to the rise in property value for surrounding properties resulting from a

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240. 11 U.S.C. § 928.

241. 11 U.S.C. § 902(2).

242. House Report No. 100-1011, 100th Cong., 2d Sess. 6-7 (1988).



public improvement that causes property values to rise, even if the receipts are collected as part of a general tax levy;

4. regulatory fees derived from particular functions of the debtor, such as a stamp tax imposed on the recording of deeds;
5. taxes levied to finance a particular project, such as the construction of a stadium, but not general property, sales, or income taxes.

Disclosure may be required if there is any likelihood an issuer may file a petition under Chapter 9, and counsel has doubts whether the security is special revenues, particularly in the circumstance in which a reasonable investor would assume the revenue bonds are secured comparably to other revenue bonds. Conversely, a general obligation bond, which is generally assumed to be unsecured debt under Chapter 9, may be secured by special revenues that are protected under section 928, and that circumstance may be noted in the disclosure.

### **§ 8:7 Bank Loans**

Municipal entities have several alternatives for raising capital that do not involve a distribution of municipal securities into the public market. Since the recession, there has been an increasing use of bank loans and the sale of debt directly to commercial banks, often referred to collectively as bank loans. Since there is no public offering, it is unlikely that an offering document will be prepared that is filed on EMMA and available for review by investors, analysts, or rating agencies to determine the effect of the bank loan on outstanding municipal securities. Section 9:5.5 describes the efforts of market participants to encourage a voluntary filing of key disclosure information on EMMA or the issuer's website. Section 10:1.5 contains an extended discussion of the regulatory implications for municipal advisors and other intermediaries, who act as placement agents, finders, or solicitors, and may find themselves inadvertently acting in the capacity of "brokers" subject to registration and regulation under the 1934 Act.

Here, the issue to be addressed is whether material terms of an existing bank loan require disclosure at the time an official statement is delivered in connection with a primary offering of municipal securities. The discussion in the industry has been largely focused on "voluntary" disclosure at the time a bank loan is made, and it may be easy to overlook a subsequent securities law obligation to disclose material information about an existing bank loan that has not previously been disclosed in the marketplace. For example, assume that a regional electric utility authority is preparing a new issue of

municipal securities, and, since its last public offering, the authority has guaranteed the performance of a take-or-pay contract entered into by a small electric utility district within its area of operation. Most lawyers would agree that key information about the guarantee is probably material to the investors in the authority's new offering of municipal securities. This conclusion is a simple application of the due diligence principle that an issuer's important contracts should be reviewed to determine whether there are terms in the contracts that are material to investors. Information about an existing bank loan of the issuer should be treated similarly.

In 2015, the MSRB published a regulatory notice entitled "Bank Loan Disclosure Market Advisory."<sup>243</sup> The 2015 Bank Loan Advisory summarized a notice the MSRB published in 2012 describing the capacity of EMMA to be a central location for the voluntary filing of information about bank loans,<sup>244</sup> but then added a reminder to market participants "to be mindful of their legal responsibilities in the development of primary offering documents to fully inform investors of other debt-related obligations." This statement was followed by a due diligence reminder to underwriters: "Inclusion of bank loan information, if material, within publicly offered municipal securities documents, supports the underwriter's due diligence obligations to have a complete understanding of an issuer's debt profile and potential implications for existing and potential bondholders."

The 2015 Bank Loan Advisory cited recommendations for bank loan disclosure practices made by the National Federation of Municipal Analysts, the Government Finance Officers Association, the National Association of Bond Lawyers, and the rating agencies. The MSRB listed the topics that should be considered for disclosure, and these topics provide a useful checklist for market participants to consider not only for voluntary disclosure when the bank loan is made, but also for consideration at the time an official statement is being prepared for a new issue of municipal securities.

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243. MSRB Notice 2015-03, Bank Loan Disclosure Market Advisory (Jan. 29, 2015) [hereinafter 2015 Bank Loan Advisory].

244. MSRB Notice 2012-18, Notice Concerning Voluntary Disclosure of Bank Loans to EMMA (Apr. 3, 2012).