Preparation of Official Statements: Interplay between Disclosure Counsel and the Client

Thursday, May 18, 2023

Jeffrey Masey, Senior Deputy City Attorney, Sacramento
Lawrence Chan, Shareholder, Stradling Yocca Carlson & Rauth

PREPARATION OF OFFICIAL STATEMENTS – INTERPLAY BETWEEN DISCLOSURE COUNSEL AND THE CLIENT

Presented at

LEAGUE OF CALIFORNIA CITIES
2023 City Attorneys Spring Conference

Thursday, May 18, 2023, 9:45-11:15 a.m. General Session
Hyatt Regency Monterey

JEFF MASSEY, Senior Deputy City Attorney, City of Sacramento (Panelist)
LAWRENCE CHAN, Shareholder, Stradling Yocca Carlson & Rauth (Panelist)

SUSANA ALCALA WOOD, City Attorney, City of Sacramento (Session Moderator)

OVERVIEW

State and local governments, some occasionally and some routinely, borrow money among other purposes, to finance infrastructure, to fund cash flow needs, or to refinance existing borrowings. Such borrowings are commonly structured as bonds, notes, certificates or other debt instruments and sold to the public market. When such municipal securities are sold to the public market, they are subject to securities antifraud rules which, as further discussed below, require that potential investors be provided with all information necessary to make an informed decision as to whether to purchase the security.

The document by which a municipal issuer (e.g. a city, county, school district, utility district, etc.) typically discloses the necessary information to a potential investor is referred to as a "Preliminary Official Statement" or "Official Statement" (referred to herein as the "Official Statement"). Note, for any issuance of a municipal security, the Preliminary Official Statement is used to solicit potential investors and becomes the final "Official Statement" once the securities are sold and the final pricing-related terms of the securities (e.g. maturity dates, principal amounts, interest rates, prepayment terms) are incorporated into the Official Statement.

Historically, counsel to the underwriting bank on a municipal securities offering would be the primary drafter of the Official Statement. Over the last few decades, in part as a result of the U.S. Securities and Exchange Commission (the "SEC") making it clear that the Official Statement is the *issuer's* document and the *issuer* is responsible for the content therein and any material omissions therefrom, it has become common practice for the issuer to retain counsel to serve as "Disclosure Counsel." The role of Disclosure Counsel is to assist the issuer in preparing the Official Statement and to be the primary drafter of all or a portion thereof. Since Disclosure Counsel is engaged by the issuer, Disclosure Counsel has an attorney-client relationship with, and a fiduciary duty to, the issuer.

This paper will provide an overview of: (1) the typical contents of an Official Statement, the legal standard under federal securities law that an Official Statement must satisfy, and potential consequences of inadequate disclosure, and (2) the process by which issuers and issuer's counsel generally work with Disclosure Counsel to prepare and finalize the Official Statement.

This paper only addresses the federal antifraud rules in the context of Official Statements prepared for primary security offerings. It should be noted that such antifraud rules apply in other contexts in which the SEC may deem that the issuer is "speaking to the market" (e.g. ongoing financial reporting, press releases and public speeches by an issuer's executive officers or elected officials).

I. Overview of the Contents of an Official Statement.

The Official Statement is the equivalent to the prospectus provided to potential investors in the corporate setting. Under the federal antifraud rules described below, the Official Statement must not contain any "material" misstatements and must contain all "material" information (i.e. no material omissions). The concept of "materiality" will be discussed in more detail in Section II below.

An Official Statement will generally include, among others, the following information:

A. Terms of the Securities.

The Official Statement will describe the basic terms relating to the repayment and prepayment/redemption of the securities and any other structuring features that are applicable or unique to the security. These include, but are not limited to:

- Dates on which interest and/or principal are due to the investor.
- Maturity date(s) of the securities.
- Prepayment/redemption features, which describe the dates, the circumstances under which and in certain instances, the proceeds from which the issuer may prepay the debt.

B. Source of Funds and Security for Repayment.

The Official Statement will describe the pledge of funds to repay the securities and the funds and accounts from which the securities will be repaid.

For example, in the context of a property tax-secured transaction (e.g. a general obligation bond or bonds issued pursuant to the Mello-Roos Community Facilities Act of 1982 (the "Mello-Roos Act"), the Official Statement will describe the authority for the levy of the tax, the pledge of the tax and the transfer of funds to repay the securities. The Official Statement will also typically describe the taxation method, the property tax base (e.g. value of the property, largest taxpayers, status of development and impediments/risks to development (if not fully developed) and any history of property tax delinquencies. In the context of a general fund-backed or enterprise revenue transaction, the Official Statement will describe, among other items, the general fund or enterprise's historical performance, budgetary forecast, any financial or operational risks and planned future borrowings.

C. General and Specific Risk Factors.

The Official Statement will typically provide a summary of certain risk factors relevant to the nature of the security being offered. For example, for property tax/land-secured securities, the Official Statement would typically discuss risks that could erode the property tax base (e.g. failure to complete development, natural hazards, environmental issues). In addition, investors are also typically cautioned regarding the potential for changes in state laws that may result in challenges to raising revenue sources (e.g. Proposition 218 and Proposition 26), and federal law with respect to the tax treatment of interest on the securities.

Disclosure of risks specific to a particular offering may be warranted under certain circumstances. For example, the property relating to a land-secured security may be subject to ongoing environmental remediation, which increases both the cost to develop and the risk that the land may remain undeveloped.

II. Legal Standard for Official Statements.

A. Key Antifraud Provisions.

Two key antifraud provisions under federal law are applicable to municipal securities – Section 17(a) of the Securities Act of 1933 and Rule 10b-5 promulgated under the Securities Exchange Act of 1934. Section 17(a) of the Securities Act of 1933 states as follows:

"It shall be unlawful for any person in the offer or sale of any securities…(1) to employ any device, scheme, or artifice to defraud, or (2) to obtain money or property by means of ***any untrue statement of a material fact or any omission to state a material fact*** necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

Under Section 17(a), a negligence standard is applied, meaning that the SEC can successfully show a securities fraud violation if the issuer "knew or should have known" of the misstatement or omission.

Rule 10b-5 states as follows:

"It shall be unlawful for any person…(a) to employ any device, scheme, or artifice to defraud, (b) to ***make any untrue statement of a material fact or to omit to state a material fact*** necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

Under Rule 10b-5, the SEC must show that the violation was intentional or the issuer acted recklessly.

B. The "Materiality" Standard.

As described in Section II.A. above, misstatements or omissions in an Official Statement are violative of the antifraud provisions if they are "material." The SEC has never defined what would be considered "material." The concept of "materiality" has been interpreted and guided by court cases and SEC enforcement actions. The commonly articulated standard of whether a piece of information is material is that there "must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the *total mix* of information made available." The question to be asked when preparing an Official Statement is whether a particular piece of information or fact would be important to, or would sway, a potential investor in their decision as to whether or not to purchase the security.

III. Consequences of Violations of the Antifraud Rules.

A. SEC Enforcement Actions.

The SEC undertakes investigations and enforcement actions with respect to municipal securities offerings, which have increased in frequency in recent years. Whether or not the SEC ultimately charges an issuer and staff, the process can be time consuming and expensive for the issuer. It is important to note that an SEC investigation is not litigation, which means that rules of court in a typical lawsuit are generally not applicable. The SEC will generally issue broad document subpoenas as well as personal subpoenas to the issuer's officers and staff. SEC investigations have no set timeline or budget. The process can result in the issuer committing significant staff time and resources as well as significant legal, accounting and other consulting expenses.

Most enforcement actions result in settlements with the SEC. Settlements have taken various forms and the following are certain of the consequences that have resulted from settling enforcement actions:

- Monetary fines against the issuer and individuals (i.e. officers and staff).
- Prohibition of individuals involved with the alleged violations from future participation in any securities offering.
- The SEC can require that the issuer implement procedures to promote future compliance with the antifraud rules. This can take the form of requiring the issuer to hire third-party consultants to monitor compliance.
- The SEC can require that the issuer disclose the settlement in the issuer's Official Statements with respect to future securities offerings.

In addition to the foregoing penalties and sanctions that could be imposed by the SEC, an enforcement action and the settlement thereof could result in the reduced ability or inability for the issuer to access the public securities market for a certain period of time. If the issuer does access the public market, the market may impose an interest rate penalty as a result of the enforcement or

settlement. Such challenges could pose operational and financial difficulties for the issuer beyond any immediate penalties that the SEC imposes.

B. Examples of Enforcement Actions.

- **Westlands Water District** ("Westlands"): In 2010, Westlands reclassified approximately $8.3 million received in prior years as well as approximately $1.46 million in reserves to include such amounts as revenues for fiscal year 2010. In 2012, Westlands recorded a prior period adjustment for fiscal year 2010 which reclassified approximately $8.4 million, previously included as a capital expense, as an operating expense (in effect increasing operating expenses for fiscal year 2010). The foregoing accounting transactions were approved by Westlands' auditors. In 2012, Westlands issued a series of bonds and in the related Official Statement, Westlands disclosed the foregoing accounting transactions. However, Westlands did not explain the effect such accounting transactions would have had on Westlands' debt service coverage ratio for fiscal year 2010 (i.e. the ratio of revenues to the amount of debt service payable). The SEC charged Westlands, the general manager and the assistant general manager with violations of the antifraud rules as a result of such omission.

  Westlands and the officers charged in the enforcement action settled with the SEC. Westlands agreed to pay a fine of $125,000. The general manager and the assistant general manager paid $50,000 and $20,000, respectively, to settle the charges.

- **Sweetwater Union High School District** ("Sweetwater"): In 2018, Sweetwater's current year budget and interim financial reports showed that Sweetwater would end the fiscal year with a general fund balance of approximately $19.5 million. In reality, as a result of previously approved payroll increases that were not reflected in the budget and interim financial reports, Sweetwater was actually projected to end the fiscal year with a general fund deficit of $7.5 million. The inaccurate projections were incorporated into the Official Statement for a bond offering in 2018.

  Sweetwater and Sweetwater's then-chief financial officer settled the enforcement action with the SEC. Among other requirements, Sweetwater agreed to engage an independent consultant to evaluate its policies and procedures related to its municipal securities disclosures. The chief financial officer agreed to pay a $28,000 penalty and was barred from participating in any future municipal securities offerings.

IV. Role of Disclosure Counsel.

Disclosure Counsel will generally be tasked as the primary drafter of the Official Statement. However, while Disclosure Counsel drafts and prepares the Official Statement, the information therein will be drawn from multiple sources which, depending on the type of transaction, may come from the issuer, third-party consultants or other financing participants (e.g. a developer in the context of property tax/land-secured transactions).

The appropriate Disclosure Counsel on a particular transaction should not only have federal securities law and relevant state law expertise but should have experience with the type of security being offered and issues surrounding the source of repayment. For example, Disclosure Counsel hired for a water utility enterprise financing should have sufficient familiarity with water utilities from both an operational and financial perspective. Disclosure Counsel hired for a land-secured transaction should have familiarity with the process of real estate development, factors that could impede development and risks surrounding investments secured by real estate in general.

Oftentimes, the same firm that is serving as bond counsel on a transaction will also serve as disclosure counsel.

V. Process of Preparing Official Statements.

A. General. The general process for preparing an Official Statement initially involves Disclosure Counsel, through its own due diligence (e.g. review of relevant documentation and research) and through discussions/communication with the issuer, issuer's counsel and other financing participants, preparing a first draft. However, depending on the issuer (generally very large and frequent issuers), the preparation of the disclosure regarding the operations and finances of the issuer in general-fund and enterprise revenue transactions may instead be initially drafted or updated by the issuer internally and then provided to Disclosure Counsel to prepare the subsequent drafts.

After the initial draft is produced, a meeting is typically held among the members of the financing team to review and discuss the draft. Subsequent drafts will similarly be reviewed and discussed with the financing team. When the Official Statement is in substantially final form, it will be presented to the issuer's legislative body for approval before being released to potential investors.

B. Nuances Depending on the Deal and Interplay with Disclosure Counsel.

Section A above outlined, at a high level, the process of preparing an Official Statement. In real-time, the communications between Disclosure Counsel and the issuer as well as other members of the financing team that occur frequently are key to the due diligence process and the shaping of information that is ultimately included in the Official Statement.

This section will highlight some of the differences by which due diligence is conducted and information is gathered for Official Statements depending on the type of security, using property tax/land-secured financings and general fund and enterprise revenue financings as examples.

Property Tax/Land-Secured Transactions. Many property tax/land-secured transactions involve a development project that is not complete. In such transactions, it is inherent that the developer, rather than the issuer, will be the party with a significant portion of the relevant information needed for the Official Statement. For example, in an ongoing development, the developer will have the most up-to-date information with respect to the infrastructure completed and remaining to be completed, the status of vertical development, the expected pricing (i.e. for sale and for lease products), and estimated pace of absorption. In such context, Disclosure Counsel will likely have frequent communication with the developer regarding the proposed development, and perhaps less so with the issuer, as the Official Statement is developed.

However, as Disclosure Counsel cannot solely rely in all instances on information provided by the developer, issuer staff and issuer's counsel should be engaged in reviewing the information provided by the developer and included in the Official Statement. If the development is a large-scale commercial project or of other significant importance to the community, the issuer's community/economic development, public works and/or legal departments will likely be engaged with the project. As a result, the issuer may also have in-house knowledge of the status of development, entitlements, or environmental/hazardous substance issues, if any.

The following are examples of information which the issuer may be privy to in property tax/land-secured transactions that should be raised with Disclosure Counsel:

- Proposed uses of property within the vicinity of the development that could affect value or absorption of the development.

- Disputes with the developer that may impact the proposed financing or the development.

- Threat of litigation regarding the development.

- Potential mapping or other entitlement issues that could delay or impede development.

General Fund/Enterprise Revenue-Backed Transactions. Unlike the due diligence and information gathering process for a property tax/land-secured financing described above, the information for a general fund or enterprise revenue transaction will almost entirely be drawn from within the issuer's organization. In addition, there will be differences depending on the issuer. A very large issuer (e.g. the State of California, large cities and counties and large utility districts) will generally need to draw upon the expertise of various departments (finance, debt management, risk management, legal, public works, human resources, resource management, information technology, etc.) to gather the necessary information for the Official Statement. In contrast, if the issuer is a single purpose special district (e.g. a small utility, a small school district) with a small number of staff, almost all information for the draft Official Statement may be drawn from a few individuals. In all cases, during the course of preparing an Official Statement, Disclosure Counsel should have open and frequent communication with all relevant issuer staff and counsel.

Similar to the inability of Disclosure Counsel to rely solely on developers to provide information in a land-secured transaction, Disclosure Counsel cannot uncover all material information regarding an issuer's operations and finances without the expertise of the issuer's staff and counsel. The following are examples of information that the issuer's staff and issuer's counsel should raise with Disclosure Counsel as they may not be uncovered through public sources or Disclosure Counsel's prior knowledge of the issuer's operations and financial condition:

- Significant budgetary proposals that could impact the source of repayment.

- Internal investigations of staff or other matters which may materially affect operations or finances.

- Pending or threatened litigation that may impact operations, finances or the authorization for the financing.

Most general fund-back securities in the State of California are structured as lease revenue financings in which the leasing of certain property owned by the municipality serves as the security for the financing. The legal premise for repayment of the security involves the municipality having use and occupancy of the property subject to the financing leases. The due diligence process regarding the leased property is therefore crucial from both a security and a disclosure standpoint. Such process involves, among others, vetting of any recorded and unrecorded real estate rights affecting the proposed leased property and any natural or environmental hazards. Any issues uncovered that could materially impact the issuer's right to use and occupancy of the property would be disclosed in the Official Statement or could instead render the property unusable for the financing. Failure to have appropriate issuer staff and counsel involved in the due diligence process could result in an omission of material information concerning the property in the Official Statement or the improper use of such property as security for the offering.

The following are examples of issues that have been uncovered in the context of general fund lease transactions:

- During discussions with the issuer, it was discovered that there were plans in the near term to demolish and rebuild the property in question. As a result, the decision was made to use an alternate property as security for the transaction.

- The due diligence process discovered that significant portions of the property was leased to a third-party user, requiring the agreement of the existing user to subordinate their lease to the financing leases.

- The property was subject to reversionary rights to the prior owner under certain circumstances, requiring disclosure in the Official Statement.

C. Establish Procedures.

While the process for preparing an Official Statement can vary depending on factors such as the type of security (as described above), the SEC has stated that issuers should establish a written policy or procedure for preparation of Official Statements by appropriate staff and issuer's counsel (e.g. the city attorney, general counsel). As an example, such procedures could require that certain staff members review and approve of the sections of an Official Statement for which they are the subject matter experts before the Official Statement is provided to more senior officers for a comprehensive review. The process and procedures should not be overly rigid and should be tailored to fit how the particular municipality operates.

VI. Conclusion.

When a municipality issues securities to the public market, the SEC has made it clear that the municipality is subject to the antifraud rules described above and that the issuer is ultimately

responsible for the contents of and material omissions from the Official Statement. Violation of such rules can have serious legal, financial and reputational consequences for the municipality and the individuals involved. It is therefore crucial that the key staff and the legislative body "buy in" to the idea that providing accurate and complete disclosure to investors is important and to be taken seriously. Further, it is recommended that an issuer establish procedures and processes for review of its Official Statements.

It is now common for issuers to engage Disclosure Counsel to assist with preparing Official Statements. However, while Disclosure Counsel will conduct the due diligence that it deems necessary in its drafting the Official Statement, there will be information material to the offering that lies with the issuer's staff, officers and members of its legislative body (especially in the context of utility and general fund-backed securities). Therefore, it is important for the issuer and issuer's counsel to have open dialogue with Disclosure Counsel in order to best prevent any instances of inadequate disclosure.