Public Finance: Case Law Update

The past week brought several cases of interest to state and municipal bond issuers. First, in Lorenzo v. SEC, the U.S. Supreme Court found that a person who knowingly distributes false statements made by another person can be held liable as a primary violator of Rule 10b-5. Second, the SEC settled an enforcement action with the former Controller of The College of New Rochelle in connection with false statements made in continuing disclosure filings as the College's financial condition worsened. Finally, in the ongoing Puerto Rico Title III restructuring litigation, the First Circuit affirmed the U.S. District Court's decision dismissing certain bond insurer claims, agreeing that although "special revenues" retain their lien post-petition, application of special revenues to pay debt service during the pendency of the proceedings is permissible but not mandatory.

Rule 10b-5 U.S. Supreme Court Case (here)

In a win for the SEC, the U.S. Supreme Court ruled 6-2 to uphold a D.C. Circuit opinion finding "scheme liability" under the first subsection (a) (as well as liability under the third subsection (c)) of Rule 10b-5 for a "non-maker" who forwarded fraudulent statements he knew were materially untrue to potential investors. Lorenzo v. SEC, 587 U. S. ____, No. 17-1077 (U.S. Mar. 27, 2019). The second subsection, (b), of Rule 10b-5 prohibits making untrue statements of material fact and material omissions, and the U.S. Supreme Court has previously held that only "makers" have primarily liability under that subsection. Janus Capital Grp., Inc. v. First Derivative Traders, 564 U.S. 135, 142 (2011).

Lorenzo, a vice president of an investment banking company, "copied and pasted" content from his supervisor and emailed the information to potential investors, signing his name to the emails and asking recipients to contact him with questions. The lower court found that he acted knowingly, and he did not appeal this finding of scienter. Id. at 10.

Because Lorenzo was not the maker of the false statements, he did not have primary liability under Rule 10b-5(b). The Court found primary liability under subsection (a), however, which prohibits "any device, scheme, or artifice to defraud," and subsection (c), which prohibits any act that "operates as a fraud or deceit…." Id, at 2.

The case allows the SEC to bring a primary violation of Rule 10b-5 against participants who knowingly disseminate materially fraudulent information to potential investors, even if the participants did not make or have ultimate control over the statement. Accordingly, the case may result in primary violations and corresponding penalties against a broader group of individuals involved in communicating with investors in some circumstances.

The College of New Rochelle Controller; SEC Settlement

On March 28, 2019, the SEC entered a partial settlement with the former Controller of The College of New Rochelle for primary or, in the alternative, secondary violations of Rule 10b-5(a)-(c) and Section 10(b) of the Securities Exchange Act of 1934, available **here**. SEC v. Borge, 19 Civ. 2787 (Mar. 28, 2019). The Controller also pled guilty to criminal charges brought by the U.S. Attorney's Office in the Southern District of New York.

The SEC settlement relates to false statements made in continuing disclosure filings in connection with the College's 1999 bonds, including in filed audited financial statements. According to the SEC complaint, "[l]ike many small private colleges, prior to 2013 the College came under considerable financial stress as student enrollment declined and tuition revenues decreased, leading to chronic cash flow issues." SEC v. Borge, at 2. (The College has announced that it is expects to close by the end of this summer.) Facing a worsening financial situation, the Controller is said to have taken a number of steps to conceal the trend from College leadership, the Board and investors, including funding operating expenses from designated endowment funds without required Board approval, intentionally withholding required payroll tax payments, overstating donor receivables, not recording vendor receivables as received, and falsifying information in the College's financial statements, of which he was the primary author. According to the SEC complaint, "the College's FY 2015 financial statements … falsely reported approximately $25 million in net assets when actual net assets were approximately negative $8.8 million — an overstatement of approximately $33.8 million." Id.

The College was not charged, reflecting the steps the institution took to report and address the issues discovered after the Controller left the College. The College conducted an investigation with oversight of a special Board committee. The forensic accountant and law firm investigation found that the financial statements understated liabilities and overstated assets, and the College issued restated financial statements correcting the material misstatements.

Treatment of "Special Revenues" in Bankruptcy-Type Proceedings

On March 26, 2019, the U.S. Court of Appeals for the First Circuit affirmed the U.S. District Court's dismissal of bond insurer claims that special revenues must be applied to pay debt service during the pendency of the Puerto Rico PROMESA Title III proceedings. In re Fin. Oversight & Mgmt. Bd. for P.R., No. 18-1165, __ F.3d __ (1st Cir. Mar. 26, 2019), available **here**. The case is applicable within the First Circuit in the Districts of Maine, Massachusetts, New Hampshire, Puerto Rico and Rhode Island, but has attracted wider interest given the relative rarity of "municipal" bankruptcy proceedings.

The case may have implications for other special revenue bonds in the case of a municipal bankruptcy. Note that not all revenue or other bonds are paid from "special revenues." "Special revenues" are defined under the U.S. Bankruptcy Code to include "(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 primarily 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 or receipts derived from particular 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." 11 U.S. C. § 902(2).

Bond holders paid from pledged special revenues are entitled to certain protections in the event of a Chapter 9 municipal bankruptcy. Special revenues acquired post-petition "remain subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case," subject to necessary operating expenses of the project or system. 11 U.S. Code § 928. Moreover, notwithstanding the automatic stay, a Chapter 9 bankruptcy petition "does not operate as a stay of application of pledged special revenues…to payment of indebtedness secured by such revenues. 11 U.S. C. § 922(d).

The insurers argued that not only is the prepetition lien of special revenues protected (that is, that special revenues acquired by the debtor post-petition remain subject to the lien), but also that bondholders are entitled to continued debt service payments from special revenues during the pendency of the proceedings "to avoid debtor misuse of the property subject to the lien." In re Fin. Oversight & Mgmt. Bd. for P.R., at 12.

The First Circuit concluded that Sections 928(a) and 922(d) allow continued payment during the pendency of bankruptcy proceedings but that these payments are not mandatory. Id. at 24. "The two provisions stand for the premise that any consensual prepetition lien secured by special revenues will survive the period of municipal bankruptcy, and, accordingly, municipalities can elect to voluntary continue payment on these debts during the course of the bankruptcy proceedings so as to not fall behind and thus be at risk of being unable to secure financing in the future." Id.

The decision may affect disclosure to special revenue bondholders and may affect the market's view of the protections provided in bankruptcy, depending on its application. See, for example, Fitch Rating's report **here**.

If you have any questions on these topics of interest to state and municipal bond issuers, please contact any of our public finance attorneys.

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