TWO THOUSAND TWENTY THREE LEAGUES UNDER THE DILIGENCE SEA: A DEEPER DIVE INTO DUE DILIGENCE

Chair:

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On the heels of NABL's 2022 White Paper on this topic, this panel will consider strategies for determining what to review when conducting due diligence on certain types of transactions, considerations when diligencing third party reports and confidential information, strategies for working with issuers and issuer's in house counsel, if any, and best practices in the diligence process, including documenting due diligence.

DISCUSSION OUTLINE

Overview

I. Theories of Liability

II. Due Diligence

III. Documenting Due Diligence

I. Theories of Liability

A. Municipal securities generally have an exemption from the registration requirement of the Securities Act of 1933 (the "Securities Act"); however, NOT an exemption from antifraud provisions. Section 3(a)(2) of the Securities Act exempts certain securities from registration requirements if issued or guaranteed by the United States or any territory, or by the District of Columbia, or by any State…or by any political subdivision of a State…or by any public instrumentality." Section 17 of the Securities Act subjects these exempted securities to the "antifraud provisions" of the Securities Act which make it unlawful to obtain money in interstate commerce by means of an untrue statement of a material fact in the offer or sale of securities, or by omission of material facts even if such securities are "exempt securities."

B. Underwriters (and others) may have liability for false and misleading statements - Under Sections 11, 12 and 15 of the Securities Act, civil liability may be imposed for false and misleading statements made in connection with a primary offering of certain securities.

C. For corporate underwriters, an affirmative defense may be asserted if the underwriter shows it conducted a reasonable investigation or acted with reasonable care. Note, however the Securities and Exchange Commission ("SEC") Office of Municipal Securities also says under Municipal Securities Rulemaking Board (MSRB) rules underwriters must test the key representations in an offering document prior to making a recommendation to invest.[1]

1. Under Section 11 of the Securities Act, once a plaintiff has proved that a registration statement contains a material misleading statement or omission, the underwriter is liable for damages unless it can prove that (with respect to the non-expertised, non-official portion) it performed a "reasonable investigation" and had reasonable grounds to believe in the accuracy of the registration statement.
2. Under Section 12 of the Securities Act, once a plaintiff has proven that prospectus or oral communication contains a material misleading statement or omission, the underwriter is subject to rescission of the sale of the underwritten security unless it can prove that it did not know, and in the exercise of *reasonable care* could not have known, of the misleading statement or information. (Emphasis added)

[1] See footnotes 23-28 in NABL Due Diligence Considerations in Primary Offerings White Paper.

3. For municipal underwriters, under Section 10(b) of the Securities and Exchange Act of 1934 (the "Exchange Act") and SEC Rule 10b-5, a plaintiff must prove not only a material misleading statement or omission in the disclosure document, but also that the defendant acted with scienter, i.e., with recklessness or intent to deceive.

D. Liability for Controlling Person - Under Section 15 of the Securities Act, a person who controls anyone liable for a material misstatement or omission under Sections 11 or 12 of the Securities Act is jointly and severally liable, unless controlling person had neither knowledge of nor reasonable ground to believe in the existence of the fact that should have been disclosed.

E. Burden of Proof and Standards of Liability.

1. For registered securities: Upon a showing of a material misleading statement or omission in a prospectus, the defendant underwriter must prove that it did not act in a negligent manner.

2. For municipal securities: The plaintiff must prove, among other things, that the defendant underwriter acted with scienter.

Note: If a municipal underwriter has performed procedures which would establish a due diligence defense under Section 11 of the Securities Act, then those procedures should be sufficient to defeat a claim that the underwriter acted with scienter. A failure to follow those procedures, however, would not result in liability under Section 10 and Rule 10b-5 unless each of the elements of a Rule 10b-5 cause of action is proven by a plaintiff.

II. **Due Diligence**

A. Purpose of Diligence -

1. Establishes affirmative defenses for the underwriter from liability under Sections 11 and 12 of the Securities Act from claims that a registration statement or an offer of the sale of securities contained materially false and misleading statements.

2. Negates scienter for purposes of Section 10b and Rule 10b-5 and other anti-fraud provisions (so-called "Due Diligence Defense").

3. Satisfies the general standard of professional performance expected of the industry.

4. Supports issuer's avoidance of negligence claim.

5. To conduct a "reasonable investigation" in order to establish reasonable grounds to believe in the accuracy of the offering document. Section 11 uses "reasonable investigation"; Section 12 uses term "reasonable care."

- See 1988 Release[2] and 2010 Adopting Release[3] for SEC Rule 15c2-12

B. What constitutes a "reasonable investigation"?

1. Diligence questionnaires
   - What questions do you ask and to whom?
   - Diligence Checklists: Ongoing debate in public finance community about the use of checklists --- use them or not?
     - *Pro*: Ensures meeting disclosure floor --- "information baseline" (referenced in Chairman Cox's whitepaper[4]).
     - *Con*: Puts artificial limit on what is "reasonable diligence," problematic in litigation where plaintiff's counsel will seek to discover, creates issue where there is a departure from a standard checklist?
   - When is it enough information?
2. Diligence calls
3. Document review
4. Meetings

C. Whose responsibility is it to conduct the investigation?

1. Engagement Letters Document
   - Meeting due diligence obligations
   - Roles of counsel
   - Appendices
   - Third party reports
   - Opinions given
2. Tasks of Underwriter's Counsel
   - Tasks that underwriter must conduct itself (not delegate)
   - Matters for which Underwriter's Counsel provides legal advice
   - Tasks delegated to Underwriter's Counsel
   - Coordination with in-house counsel.
3. Role of Underwriter's In-house Counsel.
   - Conducting Diligence.
   - Interaction between In-house Counsel and Underwriter's Counsel relating to continuing disclosure undertaking compliance.
4. How does use of Disclosure Counsel Impact Role of Underwriter's

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[2] See Securities Exchange Act Release No. 26100 (Sept. 22, 1988), 53 FR 37778 at 37788.

[3] See Securities Exchange Act Release No. 34-62184A (May 26, 2010).

[4] *Disclosure and Accounting Practices in the Municipal Securities Market*, available at https://www.sec.gov/news/press/2007/2007-148wp.pdf.

Counsel?

- Responsibilities include review of the disclosure materials.
- How are Underwriter's Counsel's responsibilities affected if Disclosure Counsel addresses its opinion to the underwriter?

D. To whom should questions be asked?

1. Conduit issues/revenue bond issues/etc.
2. GO issues
3. Working with issuers to conduct Due Diligence
   - Who is the "issuer disclosure team"?
   - What are best practices for connecting with multiple departments in a large issuer to gather appropriate information?
   - What is the responsibility of underwriter's or disclosure counsel to educate the issuer? If no disclosure counsel, does this duty fall on bond counsel?
4. Reliance by Elected Officials on Staff and Professionals.

   In the County of Orange, California report relating the investigation of the board of supervisors, the SEC noted:

   "[T]he antifraud provisions of the federal securities laws impose responsibilities on a public official who authorizes the offer and sale of securities. A public official who approves the issuance of securities and related disclosure documents may not authorize disclosure that the public official knows to be materially false or misleading … the Supervisors (in Orange County)...had a duty to take steps appropriate under the circumstances to assure accurate disclosure was made to investors…"[5]

   An SEC representative is quoted as saying, in response to the San Diego enforcement action: that elected officials and staff must read the offering documents: "*It is not possible for issuers just to rely on lawyers and underwriters to handle this alone. Public officials have a different perspective and knowledge base than members of the financing team. It is critically important that members of the legislative body and other appropriate officials outside the financing team personally review disclosure documents and speak up if they have questions...it is not reasonable for issuer officials to expect the SEC and others to overlook such conduct*."[6]

   - How do we ascertain the adequacy or accuracy of issuer certifications?

   - How do you confirm that they reviewed? Send copies of the OS to each

[5] Report of Investigation in the Matter of County of Orange, California as it Relates to the Conduct of the Members of the Board of Supervisors., Exchange Act Release No. 36761 (January 24, 1996), available at https://www.sec.gov/municipal/publicof.

[6] Regulator Urges Better Policing By Bond Issuers, L.A. Times, March 8, 2006, available at https://www.latimes.com/archives/la-xpm-2006-mar-08-fi-wrap8.2-story.html.

member of the governing body? Do members receive it sufficiently in advance to have a reasonable opportunity to review?

- Is it okay to limit issuer officials' review of an OS to particular sections?

- But what if the issuer officials do not report what they know or do not fully understand the documents (for example, the arbitrage certificate) they are signing?

- Can or should the underwriter rely on certifications from the issuer officials?

- What role does Underwriter's Counsel have in determining compliance with this standard?

E. What documents are typically requested?

1. How do you determine what information to solicit in new types of deals or deals you have never done before?

   - Analogous deals
   - Review industry reports and information
   - Connect with subject matter experts
   - Consider the sources of repayment and the risks associated therewith. If drafting "RISK FACTORS" section, what documents would you request to investigate information regarding those risks?

2. The methodology to test the key representations in an offering document is driven by the design of the offering document and the overall deal structure. Understanding the deal structure, including the project and the industry will inform what questions to ask and where to focus. What are the key representations being made in the offering document as to debt authorization, sources of payment, project feasibility, etc.?

3. Examples include:

   - Obligated person and other party meeting minutes proceedings
   - Formal debt, investment and disclosure policies
   - Audited/unaudited financial statements
   - Management letters and responses
   - Budgets
   - Publicly available information on the obligated person's website or in news sources
   - Public statements by officials of the obligated person
   - Economic data (demographics, Bureau of Labor data, Census data)
   - Litigation documents/Attorney litigation letters
   - Retirement plans
   - Industry background material (for relevant deals)
   - Appraisals
   - Market studies or feasibility reports
   - Consultant reports[7]

[7] Consultant reports used in connection with an offering (e.g., engineering and feasibility reports) may alleviate the need for firsthand diligence into the matters covered by the report and a thoughtful review of such reports may reveal areas

- Forecasts[8]
- Environmental reports, lien searches, and litigation searches[9]

F. What other places should you look?

1. Publicly available information
   - Issuer governing body records
   - Google/etc.
   - News sources
   - Property records
2. Issuer websites
   - Does the issuer's information on its website conflict with information it gives you? Recall that there is liability for statements reasonably expected to reach the market.
   - Does it matter if the issuer's website is linked in the Official Statement or not? Does it matter if the information is housed on a general page or a page specifically targeted to investors?
   - What happens if you DO find conflicting information?

G. Third Party Reports

1. Standards applicable to expertised and non-expertised portions of disclosure document.

   - If there is an expertised portion of an Official Statement (i.e., audited financial statements), the underwriter is entitled to rely on that portion as long as the underwriter has no reason to believe that the statements are not true, without having to conduct an independent investigation;

   - BUT --- See: In Re: Enron --- "if 'red flags' or other warnings are present the non-expert defendant has a duty to dig deeper...cannot blindly rely."

   - Is a feasibility report provider an "expert" within meaning of Section 11 (and therefore is the underwriter entitled to reliance defense so long as negative assurance)?

     Consider: Section 11(a)(4) of the Securities Act specifically lists accountants, engineers and appraisers as professions that give a person authority to make statements which can be relied upon within

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meriting further inquiry. For example, an engineering report for a utility system financing may include information about the condition of the system and compliance with regulatory requirements. If the report indicates the system has not complied with regulatory requirements, this information and the obligated person's response and remedial plan may need to be addressed in the offering document.

[8] Forecasts relating to ongoing operations can be checked against past performance and current year's budget. For example, one of the keys to the usefulness and reasonableness of any forecast is whether the first year in the forecast is consistent with current operations.

[9] In conduit offerings or project finance and real estate backed transactions, third-party lien searches, title reports, environmental reports, and litigation searches, may provide verification of certifications and disclosure provided by the obligated person and alert counsel and the underwriter to other potential risks.

the meaning of Section 11.

2. What level of diligence should you undertake on third party reports?
   - How much should you know?
   - When should you tag in "subject matter experts" from inside your firm?
   - Consider the use of agreed upon procedures
   - In the context of financial statements, does the standard of your review change if the financials are audited vs. unaudited?
     - 2022 SEC enforcement cases: Crosby Independent School District (Texas), Anthony Michael Holland, City of Rochester all dealt with financial statements in some form (fake/fraudulent /false financials, outdated financial information)
       - Enforcement actions included case against the school district
     - How does this impact your ability to rely on third party reports?
3. What if a third-party report reveals a particular problem? Does it need to be corrected? Is it sufficient that the issuer/obligor is taking steps to address the issues? How does this impact the description of risks and risk factors in the official statement?
   - Are there circumstances where it might be appropriate to meet with the source of the third-party report (feasibility consultant, auditor etc.)?
4. When/how should you obtain consent from a third-party report provider to use their report?
   - What representations should you require, and to whom should they be addressed?
   - What if the provider will not consent to use of their report as an attachment to the Official Statement?

H. Third Party Opinions
1. To whom will these be addressed?
2. ESG Third Party Opinions
   - Understanding the scope of the Opinion
   - What is the framework of the Opinion and is this consistent with previous representations of the Issuer?
   - Managing the level of disclosure of the process in developing the Third Party Opinion.

I. Presence of Red Flags.
1. Throughout the due diligence inquiry, regardless of the scope of engagement or type of offering, counsel should be alert to "red flags" that suggest further inquiry is warranted. For example:
   - Active Litigation Matters: Need to determine the nature of the claims at issue, the status of the litigation, the amount at dispute, and whether an unfavorable decision would have a material impact on the obligated person. Is litigation matter covered by insurance?

- Outdated financial information: Is there more recent financial information available? For governmental entities, there are likely periodic budget reports presented to the governing body.
- Dramatic revenue trends or missed financial covenants: What is the source of the trend or circumstances leading to the covenant breach, and are the circumstances recurring?
- Management or employee turnover: Was the turnover planned (for example, retirement) or unplanned? Is there a succession plan?
- Environmental reports noting significant recognized environmental conditions: Are these subject to federal or state investigation, and what is the magnitude of potential expense or liability?
- Significant public opposition to a project at public hearings or in local media: Depending on the status of the approvals, will the public opposition interfere with or affect final approval of the securities or the project?
- Feasibility studies that rely upon dramatic increase in revenues: What is the sensitivity analysis of the revenue projection?

2. Example of red flags: *Sterlington, Louisiana*[10] enforcement proceeding
   - SEC brought forward charges of fraud against the mayor and the Town's financial advisor relating to the use of fictitious financial projections in applications to the State Bond Commission and failure to disclose misuse of proceeds from previous bond issues. Such applications were provided to investors as part of a solicitation for the offering. In addition, the Town's mayor provided a certification that the bonds were "authorized by and issued in conformity with the requirements of the constitution and statutes of the State of Louisiana." No official statement was produced and the bonds were privately placed.
   - What if these bonds had been publicly offered? What would the diligence process have looked like? If a thoughtful comprehensive diligence process had been undertaken would the weaknesses/discrepancies in projections have been uncovered prior to sale?
   - Consider the reliance on certifications of the issuer by the investors. What does this say about the ability of counsel to rely on such certifications?

J. Determining Compliance with Continuing Disclosure Undertakings

1. What are the appropriate procedures or best practices for Underwriter's Counsel?

[10] *In re: Town of Sterlington, Louisiana*, Securities Act Release No. 11609, Exchange Act Release No. 95024, June 2, 2022.

2. Consider SEC 2022 enforcement case against Anthony Michael Holland[11]

- Holland was the Chief Administrative Officer of the City of Johnson City, Texas. Holland was embezzling funds from the City, and to cover this up he created a fake financial report for fiscal year 2016 by essentially "marking up" the financial statements for 2015. This false financial statement necessarily contained material misstatements and omitted to disclose Holland's embezzlement of funds from the City. After the embezzlement was finally uncovered, Holland was criminally charged.

  Holland provided the falsified documents to the City's mayor and municipal advisor, knowing that the material would be posted to the city's public website and EMMA website to comply with continuing disclosure obligations for an earlier bond issue. They remained on EMMA for almost a year until the fraud was uncovered. In mid-February 2020, a financial examiner with a State of Texas entity, which was an investor in the City's 2015 securities, discovered the falsified documents that had been posted on EMMA. The investor alerted the City's auditor, which then notified the City about the falsified documents and that the fiscal year 2016 financial statements had not yet been audited.

- If there had been an ongoing bond issue, would there have been any obligation to review such past financials? What if irregularities had been discovered in the process of due diligence and review of such past financials?

K. Confidential Information

1. Is anything actually "confidential" in the diligence process? What obligations does the underwriter and Underwriter's Counsel have to disclose information if material to the offering, but considered confidential by the issuer or obligor?
2. Can Underwriter's Counsel sign a non-disclosure agreement? SHOULD Underwriter's Counsel sign such an agreement?

III. Documenting Due Diligence

A. The SEC and FINRA have both stated broker-dealers must retain documentation of their due diligence process.

B. Depending on an underwriter's written policies and procedures, underwriter's counsel may be asked to assist with the retention of written documentation of the conduct of due diligence, or may be asked to provide such documentation in the case of a regulatory exam.

C. The extent of counsel's participation in documenting the due diligence process

[11] *Securities and Exchange Commission v. Anthony Michael Holland*, Case 1:22-cv-00590-LY, U.S. District Court, Western District of Texas; SEC Release No. LR-25426 (June 16, 2022), available at https://www.sec.gov/litigation/litreleases/2022/lr25426.htm.

should be addressed in counsel's engagement letter or otherwise as early in the transaction as possible.

D. Are there document retention guidelines in law firms with respect to notes/document drafts/diligence memos?

1. Consider if specific advice has been given to the client, but client did not heed such advice.

2. There is a wide divergence among counsel about creating and/or retaining documentary evidence of the conduct of due diligence on behalf of an underwriter (such as a formal due diligence memorandum), some of which is dictated by internal law firm policy, as well as the relationship with the particular underwriter making such request.

3. As a general rule, files could be stored for the statute of limitations period for an anti-fraud action, that is, five (5) years. Underwriters are subject to their own special document retention requirements under SEC and MSRB rules.