

Practical Due Diligence Drafting the Disclosure Document

Deanna L.S. Gregory
Pacifica Law Group LLP
Seattle, WA

Ahmed Abonamah
City of Cleveland
Cleveland, OH

T. Parker Schenken
Sherman & Howard L.L.C.
Denver, CO

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The Essentials
APRIL 19–21, 2023

What We Will Cover



Purpose of Due Diligence



Purpose of Disclosure Document



Contents of the Disclosure Document



Gathering & Verifying Information Included in Disclosure Document



Other Due Diligence/Disclosure Document Topics

Purpose of Due Diligence

Depends on your role in the transaction

The term “due diligence” is not defined in the federal securities laws but refers to the investigation into the business, legal and financial affairs of an entity involved in a securities offering or other corporate transaction. It is also used as an informal shorthand phrase to mean the process by which securities or common law liability can be avoided by an underwriter which can show that any fraud that occurs in a bond transaction could not have been detected by a reasonable inquiry or “due diligence”.

Underwriters – Due Diligence

The purpose of an underwriter's due diligence investigation is to “establish a reasonable basis for belief in the truthfulness and completeness of the key representations” made in the Official Statement.

- **Registered Securities** – Section 11 of the 1933 Securities Act establishes the affirmative due diligence defenses available to an underwriter of securities subject to SEC registration in response to a liability claim made by a purchaser
- Although municipal securities are not subject to liability under Section 11 of the 1933 Securities Act, Section 11 provides by analogy useful guidance for establishing defenses to liability under Section 10(b) of the 1934 Exchange Act

Due Diligence Defenses

Statutory Due Diligence Defenses for Registered Securities – Upon a showing of a material misleading statement or omission in a registration statement, the defendant underwriter must prove that it did not act in a negligent manner.

Due Diligence Defenses for Municipal Securities – The plaintiff, including the SEC, must prove, among other things, that the defendant underwriter acted with *scienter* in accordance with the requirements of Section 10(b) of the 1934 Exchange Act, or, with respect only to the SEC as plaintiff, negligence, under Section 17(a)(2) or (3) of the 1933 Securities Act.

Roles of Underwriters and Counsel

In conducting a due diligence investigation, there are

- (1) certain tasks that the underwriter must conduct itself (e.g., revenue projections);
- (2) certain matters as to which counsel is, in effect, rendering legal advice (e.g., whether a security interest has been perfected); and
- (3) certain tasks may be delegated to underwriter's counsel as agent of the underwriter, but that do not amount to legal advice (e.g., reviewing corporate minutes or material contracts).

Disclosure Rules of Counsel In State and Local Government Securities Offerings, 3d ed. ABA (2009), at 144.

Roles of Underwriters and Counsel (cont'd)

“The underwriter is responsible for all due diligence, whether performed by itself or on its behalf by agents such as underwriter’s counsel, and can be held responsible not only for its own actions or inactions, but also for those of its attorneys and agents.”

“Many bankers, even experienced ones, believe that it is the responsibility of underwriter’s counsel to lead and manage the due diligence process, and that the underwriter can confine its role to assessing the credit, coordinating with rating agencies and insurers, and marketing the bonds. *That view is misplaced.*”

Disclosure Roles of Counsel at 145.

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Important Considerations

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|--|
| <ul style="list-style-type: none">• Who's your client and what level of investigation are they expecting you to make?<ul style="list-style-type: none">• Determine if there is an engagement letter or memo in place (and discuss if it is over or under inclusive). |
| <ul style="list-style-type: none">• Obtain and verify information regarding issuer, authorization, use of proceeds and security for bonds. |
| <ul style="list-style-type: none">• Review potential problems with the financing or the project<ul style="list-style-type: none">• Environmental issues, pending litigation, limit the authority of the issuer or impose significant liabilities, or state or federal legislation that will be enacted during the term of the bonds that will negatively affect the revenue stream. |
| <ul style="list-style-type: none">• Comfort to deliver 10b-5 opinion even if you are not serving as disclosure counsel. |
| <ul style="list-style-type: none">• Tax issues<ul style="list-style-type: none">• The performance of due diligence permits the issuance of the tax opinion and will help show compliance with statutory/regulatory requirements of issuer. |
| <ul style="list-style-type: none">• Establish a defense to securities liability, provided that the inquiry satisfies the general standard of professional performance expected of the underwriter and certain other professionals. |

Important Considerations (cont'd)

Past Compliance with Continuing Disclosure Undertakings

- Rule 15c2-12 requires that final official statements contain “a description of the undertakings to be provided...and of any instances in the previous five years in which each [obligated] person failed to comply, in all material respects, with any previous undertakings in a written contract or agreement.”
- The SEC has stated that sole reliance, without independent inquiry, on representations of an issuer is not sufficient.

Important Considerations (cont'd)

- Whether in a competitive or negotiated sale, it is critical that review of prior continuing disclosure compliance is undertaken and documented, and that past “failures to comply in all material respects,” are disclosed in the offering document.
- Who is responsible for reviewing prior compliance?
- Has there has been a history of noncompliance? What has changed?
- Has the issuer adopted policies and procedures addressing disclosure matters?
- Diligencing listed events 15 and 16
 - Best practices and considerations

Purpose of the Disclosure Document



Provides information to potential investors need to make an investment decision.



Drafts may be used to provide potential credit enhancers, rating agencies and others data about the use of the bond proceeds, the project and sources of security for payment.



Assists with marketing the securities.



Contains information material to a reasonable investor.



Tool to mitigate against risk.



After closing, used by parties to the transaction for a quick reference that summarizes the terms of the deal.

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Contents of the Disclosure Document

Disclosure document

Official statement or limited offering memorandum or private placement memorandum, depending on how the bonds are being sold.

“Preliminary” version of the disclosure document may be distributed prior to sale

Preliminary Official Statement is “deemed final” for purposes of Federal Securities Laws, but may exclude certain specific information related to pricing, such as final numbers, redemption terms, and so on.

Contents of the Disclosure Document (cont'd)

Description of the bonds and relevant bond documents

Description of security and matters affecting security

➤ Is it a general obligation of revenue transaction?

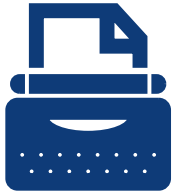
Information concerning the issuer/borrower (organization, operations and financial data, powers/authority, important decision makers)

Contents of the Disclosure Document ("Boilerplate" Language)

Boilerplate" information on the inside cover

- Not Solicitation
- Information subject to change
- No guaranty of information by underwriter
- Official Statement considered in entirety
- Not recommended by any governmental body
- Forward looking statements
- Transactions to stabilize market price

Contents of the Disclosure Document (cont'd)



Bond sale numbers
(preliminary vs. final) –
prepared by
underwriter(s)



Content relating to
some third parties (e.g.
DTC, credit providers,
liquidity providers)
prepared by those
parties



Differences in the
document when a
competitive sale
(including who
prepares)

Contents of the Disclosure Document (cont'd)

Risk factors

Limitations on potential purchasers

Tax information

- Exempt? Taxable? Bank qualified? Alternate Minimum Tax? Tax Credit Bonds?

Ratings (or non-rated)

Litigation

Continuing disclosure undertaking

Summary of material noncompliance over prior five years

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A Word on Climate Change, ESG, and COVID-19

Climate issues (e.g., flooding, hurricanes, extreme heat/drought, etc.). This is an area that is taking on more importance each year. Climate change potentially affects all core functions of government, including energy, land use, emergency management, public health, transportation, water, and agriculture. Climate change risks are becoming clearer for municipal issuers and market participants are counting on more disclosure about how those risks affect credit and global investor perceptions of the market.

Current risk factors such as cybersecurity. Consider any current guidance on such topics (including from the SEC or other industry groups).

A Word on Climate Change, ESG, and COVID-19

ESG refers to three key factors that affect a government's credit profile, including an exposure to climate risk and other Environmental factors ("E"), long-term Social factors ("S"), and Governance issues ("G").

ESG factors represent areas affecting the long-term sustainability of a community. Both investors and rating analysts have increasingly utilized outside resources to assess ESG risks for municipal issuers.

Considerations:

Labeled bonds vs. ESG risk factors

Gathering and Verifying the Information Included in the Disclosure Document



Consider who is conducting due diligence and who is providing information



Questionnaires/Lists



Focus on items affecting the issuance and repayment of the bonds



Ask for (and review!) back-up documentation

Gathering and Verifying the Information Included in the Disclosure Document (cont'd)

Examples

- Board minutes/articles of incorporation/by-laws (if applicable)
- IRS determination letters
- Form 990s (if applicable)
- Changes in auditors
- Financial statements (3-5 years) and related auditors letters
- Current enacted budget and proposed budget and prior budgets (for comparison)
- Publicly available economic data and forecasts (e.g. census data, labor statistics)

Gathering and Verifying the Information Included in the Disclosure Document (cont'd)



Issuer's (or borrower's) strategic plan (if applicable), capital plan and annual report



Evidence of issuer/borrower indebtedness unrelated to financing and any material agreements involving the issuer/borrower



Licensing and accreditation, material compliance with a licensing authority, evidence of good standing



Make sure to check prior annual and material event filings on EMMA

Gathering and Verifying the Information Included in the Disclosure Document (cont'd)

Evidence of conflicts of interest policies and any reported conflicts

Litigation documents, litigation letters submitted in connection with audits and regulatory notices

Title report(s) regarding project realty and any other property to be pledged as security for the bonds

Environmental assessments, appraisal, zoning, surveys and insurance

Indentures, borrowing agreements, lending agreements, major leases and key contracts

Industry background materials

Investment policies

Swaps and other derivatives

Pension actuarial valuations

Information provided to rating agencies

Cybersecurity policies and related insurance, details of any cyberattacks

Flood, earthquake and other related insurance, information regarding recent occurrences

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Gathering and Verifying the Information Included in the Disclosure Document (cont'd)

Explain expected use of information and any certificates that will be required at closing (establish that it is the underwriter's duty to probe and to cross-check information)

How formal does this really have to be? Meetings? Calls? Conferences?

How far do you have to dig behind an answer? Examples of independent verification:

- Continuing disclosure filings on EMMA
- Filings with federal, state and municipal entities
- Press releases, promotional materials and media articles
- Online research and research through services such as Lexis-Nexis or Westlaw

Gathering and Verifying the Information Included in the Disclosure Document (cont'd)

Updating a prior disclosure document (pros and cons)

Follow-up due-diligence/document review sessions (if necessary)

Looking for trends in historical data

Sources of information for learning about and understanding financial reports

Consents to Include Information in Disclosure

Auditor's (1) consent (or inclusion) letter and (2) agreed-upon-procedures letter (or evidence that inclusion is otherwise permitted)

Feasibility and other studies

Rating Agencies?

Other consents

Certificates and Opinions Supporting Information Provided

Certificates and opinions from

- (1) issuer and issuer's counsel
- (2) borrower and borrower's counsel in conduit issues; and/or
- (3) a state/county/city in municipal-supported or appropriation backed bond issues

Certificates and opinions from credit enhancement provider

Certificates and opinions from bond counsel

Certificate from the dissemination agent/continuing disclosure review service

Opinions to the underwriter

Logistics

Getting sign-off/consent before “printing;” deeming the POS “final”

What is “printing”? (hard copies versus posting – the latest trends)

Getting the pdf document to the printer and proofing the cover and reviewing the document for “layout” issues

Dealing with attachments – coming from different parties (auditor, insurer, bond counsel, etc.)

“Stickering” or “supplementing” a POS or OS for material updates during underwriting period or errors in the document

When must the final OS must be delivered

Record Retention Issues



Drafts of official
statements and other
documents



Email



Attorney notes



File memos, materials,
diligence lists and
questionnaires (and
client requests?)

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Questions

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