SEC Targets Public Issuer and Officials for Misleading Statements in an Offering Document

On March 9, 2016, the U.S. Securities and Exchange Commission (the "SEC") issued a cease and desist order against Westlands Water District, a public agency of the State of California (the "District"), the District General Manager and General Counsel, and the former District Assistant General Manager. The SEC investigation into the District's sale of $77 million in refunding revenue bonds in 2012 (the "2012 Bonds") found that the Official Statement for the 2012 Bonds was misleading in its treatment of the District's debt service coverage ratio. The SEC Order is available here.

Background

In its simplest form, a debt service coverage ratio ("DSCR") measures net revenues to debt service obligations for a particular year and gauges whether an entity has sufficient cash flow to pay its debt service obligations. Generally, an entity with a DSCR of greater than one has sufficient cash flow to pay its current debt but an entity with a DSCR of less than one does not. In prior bond offerings, the District agreed to meet a DSCR of 1.25 and further covenanted to establish water rates and collect such amounts that were sufficient to generate net revenues equal to at least 125% of its debt service for a particular year. Failure to meet such DSCR could cause a default under the District's bonds.

In 2010, the District learned that drought conditions and reduced water supply would prevent the District from generating enough income to meet the 1.25 DSCR. In order to avoid raising water rates for its customers and still maintain its DSCR, the District, through the General Manager, Assistant General Manager and its staff, proposed reclassifying certain cash reserves and retained earnings to record additional revenue in lieu of collecting current revenue. Such proposal was submitted to an independent auditor who agreed that such transactions were permissible and subsequently issued an unqualified opinion on the District's 2010 audited financials. The General Manager and Assistant General Manager submitted such proposal to the District's Board[1] and advised that the District needed additional revenue to meet the 1.25 DSCR and the Board could either increase rates or approve the transactions. The General Manager further advised that they were engaging in "a little Enron accounting." The Board approved the accounting transactions instead of raising rates.

Separately, in 2012, the District made prior period accounting adjustments to account for expenses that would have decreased revenue for fiscal year 2010 that would have negatively affected the District's DSCR in 2010.

The Official Statement for the 2012 Bonds included information that the District had met or exceeded its required DSCR for the prior five years but the SEC noted that the information relating to fiscal year 2010 was misleading because it failed to disclose (i) that the District had "engaged in extraordinary accounting transactions solely to recognize additional revenue for purposes of calculating the debt service coverage ratio without raising rates on its customers" and (ii) the impact of the 2012 prior period adjustment and negative effect on its DSCR in 2010. The SEC order indicates that if the effect of the 2010 and 2012 accounting transactions on the DSCR had been disclosed, the District's DSCR for 2010 would have been 0.11, rather than the 1.25 which was reported in the Official Statement. The SEC further stated that the dramatic drop in the District's 2010 net revenue, its negative effect on the DSCR for such year and the effect of the 2012 prior period adjustment on the 2010 DSCR would have been material to investors in the 2012 Bonds.

The General Manager and Assistant General Manager were involved in the 2012 Bond transaction and received and/or reviewed multiple drafts of the Official Statement and signed transaction documentation, including the Bond Purchase Agreement, which included certifications that the Preliminary Official Statement and the Official Statement "contain no misstatement of material fact and do not omit any statement necessary to make the statements contained therein, in light of the circumstances in which such statements were made, not misleading." The SEC noted that both individuals were aware of the extraordinary 2010 accounting transactions used to record revenue solely to achieve the 1.25 DSCR without raising rates or charges, but did not disclose their effect on the 2010 DSCR reported in the Official Statement, nor did

1 The District's Board is elected from landowners in the District and, as a result, the District is governed by its customers.

either individual consider whether the 2010 DSCR reported in the Official Statement should be revised to show the effect of the 2012 prior period adjustment on the District's 2010 net revenue.

Legal Findings

Section 17 of the Securities Act of 1933 (the "Securities Act") includes the core anti-fraud provisions of federal securities law. Section 17(a)(2) makes it unlawful "in the offer or sale of any securities . . . directly or indirectly . . . to obtain money or property by means of any untrue statement of 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." Under current case law, negligence is sufficient to establish a violation of Section 17(a)(2) and no finding of intent of wrongdoing is required. Further, the SEC has held that the "knew or should have known" standard is appropriate to establish negligence. The SEC found that the General Manager and Assistant General Manager each knew, or should have known, that the District's revenue and DSCR for 2010 as reported in the Official Statement for the 2012 Bonds were misrepresented as a result of the extraordinary 2010 accounting transactions. The SEC also found that they were negligent for failing to consider the effect of the 2012 prior period adjustments on the revenue and DSCR calculation that was reported in such Official Statement. The negligent conduct of the General Manager and Assistant General Manager was imputed to the District.

Under the SEC order, the SEC found that the District, the General Manager, and the Assistant General Manager violated Section 17(a)(2) of the Securities Act and must cease and desist from future violations. The District, General Manager, and Assistant General Manager consented to the order without admitting or denying the SEC's allegations. Further, the District agreed to pay a fine of $125,000, and in doing so, becomes only the second municipal issuer to pay a financial penalty in an SEC enforcement action. In addition, the General Manager and Assistant General Manager agreed to pay $50,000 and $20,000, respectively, to settle the SEC charges against them.

Looking to the Future

The SEC has increased its enforcement efforts in the municipal securities area and municipal issuers, their officials and other participants can expect more scrutiny from the SEC with respect to disclosure to the market. In connection with the Westlands action, Andrew J. Ceresney, Director from the SEC Enforcement Division, stated that "Issuers must be truthful with investors and we will seek to deter such misconduct through sanctions, including penalties against municipal issuers in appropriate circumstances."

As indicated by the facts of the Westlands matter, meeting the technical requirements of financial covenants or bond documents, having an accountant approve the accounting methods and obtaining approval of the issuer's board as to the accounting is not sufficient for purposes of making appropriate disclosure to the market. Nor does it insulate an issuer or its officials from liability and financial penalties. While certain accounting methods may be permitted under the accounting rules and may technically satisfy financial covenants, issuers and their officials should use caution in relying on them and should instead secure legitimate sources of revenue (whether through levies, raising rates, etc.) before resorting to such accounting practices. Further, in preparing disclosure documents, issuers and their officials should look behind the numbers and assess the facts to determine if additional information would be material to investors and thus warranted under the anti-fraud provisions of the Securities Act.

For More Information

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