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Commentary

Moberly, Missouri Class-Action Highlights Underwriters' Duties in Muni Offerings

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Underwriters of municipal bonds have an obligation to perform due diligence on the issuer and any other individual or entity that may be required to make payments on the bonds as they come due. Recently, our firm was involved with Cromeans v. Morgan Keegan, et al., a class-action which alleged that an underwriter and underwriter's counsel failed to perform basic due diligence to determine whether a planned processing plant in Moberly, Missouri, supported by municipal bonds was feasible prior to the bonds issuing. The bonds were issued but the project failed before construction on the factory was completed due to financial and operational issues with the company for whose benefit the bonds were issued.

Cromeans was settled favorably for the class. The class recovered approximately 86% of its out of pocket losses—around $5.2 million out of roughly $6 million in bonds held by the class.

There are only a few cases which discuss in detail an underwriter's due diligence responsibilities. In 1968, the Southern District of New York stated that underwriters are ultimately "responsible for the truth of the prospectus" in the seminal case Escott v. BarChris Construction Corp. The SEC has referred to the underwriter's participation in an offering as "an implied recommendation about the securities it is underwriting." An underwriter may not accept the representations of the issuer at face value and present them to potential investors as true. As the Southern District of New York held during the 2004 WorldCom litigation, "in order to make the underwriters' participation in this enterprise of any value to the investors, the underwriters must make some reasonable attempt to verify the data submitted to them."

An underwriter's duties in issuing municipal bonds are governed by SEC Rule 15c2-12. This rule states that underwriters must "obtain and review" an official statement that is in functionally final form before bidding on, purchasing, offering, or selling the securities. Underwriters and broker dealers must make material financial and operating data in the official statement not only for an issuer, but also for any other "obligated person" available to the investors. Rule 15c2-12 defines obligated person as any person who is or may be generally or contractually required to support payments of the obligations on the securities. Failure to include or analyze the financial data, operational data, or other representations made by an obligated person could expose an underwriter or broker/dealer to liability under federal and state securities laws if the omission proves to be material.

Underwriters must review registration statements to ensure that there is no reasonable ground to

believe that the "expertised" portions contain false statements or omit material information. Expertised information includes scientific and technical information provided by experts including audited (but not unaudited or interim) financial statements. For non-expertised portions, the underwriter must conduct an investigation sufficient to allow it to come to a reasonable belief that the statements contained in the registration document are true and omit no material facts.

To meet this standard, underwriters and bankers involved in securities offerings should verify the information provided by the issuer and other obligated persons through independent sources. Underwriters should also examine the issuer and obligated persons' key business relationships, contracts, and financial statements and projections. Underwriters should familiarize themselves with the relevant industry and examine how the issuer and obligated persons' business model fits with that industry.

In most cases the underwriter is the only bulwark standing between an unscrupulous issuer and the potential investors. The underwriter must meet its obligations of impartial scrutiny of the transactions underpinning and the issuer's representations.

Finally, underwriters should take careful notes to document their due diligence activities. Prior to 2012, the industry falsely believed that opacity was a sufficient defense and retained few notes on their due diligence activities. The SEC has since made clear that underwriters need to be able to demonstrate the steps they took to determine the creditworthiness of a municipal bond offering.

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