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MEMORANDUM

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FROM: John J. Salmon
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RE: **SB 1221 Creates Significant New Uncertainties for Health Facility Bond Issuances by California Local Governments and Joint Powers Authorities**

I. Issue Overview

SB 1221 would add new community service pass through requirements for health facility bonds issued by local governments and joint powers authorities in the state. As part of this proposed change, the legislation would authorize local government and joint powers authority bond issuers to refer any "violation" of the new requirements to the office of the Attorney General "for legal action authorized under existing law or other remedy at law or equity." This open-ended requirement tracks the current enforcement provision in the pass through requirements of the California Health Facilities Financing Authority (CHFFA) statute.

The determination of what is a violation of the new standards that might lead to such a referral is itself a complex matter that might involve fact-specific questions about the community benefit plans of individual health facilities, the implementation of such plans, and the economic valuation of such plans. Although the proposal emphasizes that "remedies obtainable by the legal action shall not include withdrawal or cancellation of the project or projects financed or to be financed through the issuance of revenue bonds," that assurance provides little comfort to underwriters, bond counsel and potential investors who must assess the viability of the securities being issued rather than the potential "withdrawal" of "projects" to be financed. Rather than clarify one of the ambiguities that has diminished the attractiveness of health facility financing from CHFFA, SB 1221 would extend a similar statutory scheme to issuances by local governments and joint powers authority issuers. As discussed below, by inserting the same enforcement mechanism that is both open-ended and lacks specificity, the legislation can only impede the use of local government and joint powers authority health facility financing.

II. Disclosure Challenges for Bond Underwriters and Bond Counsel

Offering Statement. In considering the implications of the proposed new rule on health facility bond financings, the first question presented is whether the potential Attorney General

referral should be disclosed in the municipal bond offering statement for the financing in question. A municipal bond offering statement would likely fail to "state a material fact" or be materially accurate without a reference to the potential risk of an Attorney General regulatory action in such a situation. The proposed legislation does not clarify the extent and scope of the controversy which could arise; an amorphous possibility of a lawsuit can be even more foreboding than an actual dispute. How would an Attorney General action impact both the bonds already approved and issued, as well as those bonds already approved but yet to be issued? To the extent that a subsequent tranche could be denied issuance, does that denial adversely impact the viability an institution's financial ability to manage its obligations with respect to an earlier tranche?

Federal securities laws suggest that a possible attorney general "legal action" under SB 1221 would be a critical piece of information to lend material accuracy to any offering statement, especially if the transaction is circulating a 'red herring' offering statement before pricing. If the decision is made to include such a disclosure in the offering statement, it is unclear what should be the extent of the disclosure or what the impact of the disclosure might have on the viability of the transaction. Does the statement need to document past controversies with respect to community service issues at an institution's health facilities to be financed by the bonds? Are there current economic disputes in the community served by an institution's facility that might increase the likelihood of a challenge? How might the economic cost of an Attorney General-imposed remedy impact the ability of an institution to meet its debt obligations under the issuance? What are the diligence requirements of the drafter of the offering statement to understand, evaluate, and quantify such issues? These are all questions that add complexity, uncertainty, and risk to the overall financing transaction. All of these elements are matters that have a cost that is necessarily priced in the securities marketplace.

Bond Counsel Opinion. Bond counsel's issuance of a bond opinion is usually an integral part of any offering statement for a municipal bond issuance. The bond opinion addresses the organization of the issuer and its power to sell bonds, the validity of security interests and the issuance's tax exemption under state and federal laws. Any issues, omissions or inconsistencies in the offering statement itself become red flags for the bond opinion. The remedies proposed by SB 1221 create disclosure problems in the offering statement as well as in the related bond opinion given the importance of keeping a bond opinion aligned with any material disclosures in the statement. If the bond counsel is aware at the time of the transaction's pricing that the transaction could at some point be reported to the state Attorney General for failure to comply with a new community service requirement which could preclude financing, such knowledge would be a material fact that would need to be disclosed in the bond opinion. If bond counsel determines that this disclosure should have been made in the offering statement, and it is not, this could result in the issuance of an opinion that would not be "clean", and the underwriter would be unable to "release the offering." Bond counsel in these situations could be faced with the unacceptable choice of providing an ostensibly "clean" opinion that ignores the risk of a subsequent Attorney General review, or creating a situation where the bond issuance would likely fail if the bond counsel failed to deliver that "clean" opinion. It is also unclear as to what would be the diligence obligation of bond counsel to independently assess the nature of the Attorney General reporting risk.

SB 1221's open-ended Attorney General referral requirement creates significant new hurdles to all parties to a tax exempt health care financing by a local government or a joint powers authority. The complexity, uncertainty and greater risk resulting from the new rules and the disclosure challenges they pose will add additional financial burdens to the tax exempt health financing marketplace. This uncertainty will increase the time to process such transactions, increase their cost and result in some transactions losing their viability.

A more detailed discussion of the security law requirements and precedents that are central to this disclosure analysis are detailed in Section IV below.

III. Recommendations with Respect to SB 1221

Complex financing transactions are always priced on the assessment of known and unknown risk. Uncertainty in a given transaction is not in the interest of the institution seeking financing, the issuer, the underwriter, bond counsel or the investor. This is particularly true in the current complex securities financing environment. We believe that it would be preferable to measure compliance with the requirements of SB 1221 at the time of issuer approval of the health care institution's application for financing. To the extent that compliance with the community service requirements could be assessed and determined with specificity as part of the application approval process, the securities markets could manage more effectively the new requirements of the legislation. Such an approach would create a specific decision point upon which all parties to the transaction could rely. This would address many of the disclosure challenges raised by SB1221 as currently drafted.

We would recommend that both the CHFFA and the local agency sections of the legislation be modified to provide that compliance would be conclusively demonstrated if a health care institution's application for financing includes the following:

- statements confirming that it maintains a (i) policy of treating all patients without regard to ability to pay; (ii) California Medical Assistance Commission contract, or otherwise provides for the treatment of Medi-Cal eligible patients; and (iii) mechanism for reporting its costs, charges and clinical quality to the extent required by state and federal agencies.

- Copies of (i) its charity care policy; and (ii) where required by law, its most recent community benefit plan.

In addition, it is important that any discussion of remedies and sanctions in the legislation make it clear that nothing in either the legislation or any enforcement proceeding should (i) affect the validity or enforceability of any bonds issued or other form of financing provided by an issuing agency, or (ii) limit the powers or procedures by which a local agency provides financing for health facilities in or to be located within its jurisdiction.

IV. Disclosure Issues Background

A. Federal Securities Law and Other Disclosure Issues

For the issuance of corporate debt in the capital markets, the rules for disclosure are codified by the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act"). The accuracy of material information in offering documents is primarily governed by Rule 10b-5, which was promulgated under Section 10(b) of the Exchange Act. Generally, a plaintiff can establish a claim under Section 10(b) by proving that the disclosure in question has a misstatement of fact, that such misstatement was material, that the defendant acted with scienter, that the plaintiff relied upon such misstatement and that the defendant's wrongful conduct caused plaintiff's loss.[1] As interpreted by the courts, the materiality requirement means that "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[2]

Effective December 1, 2005, as part of ongoing securities offering reform, the SEC codified Rule 159. This rule provides, in part, that civil liability attaches for disclosure made to securities purchasers up to the point of sale. While this provides immunity to issuers for any information conveyed after that point of sale or pricing, all information up to a point of sale receives special import and protection under Rule 159. In its December 2005 release describing the new rule, the SEC explained that "the rules we are adopting today are focused primarily on constructive, incremental changes in our regulatory structure and the offering process" by modernizing components of the offering process and trying to eliminate unnecessary slow-downs in the system.[3] Specifically, the rule provides that "knowing of such untruth or omission in respect of a sale…means knowing at the time of such sale."[4] With the facility of email and technology to disseminate offering documents or other sensitive information, this rule clarifies that all information conveyed by the issuer right up to the point of sale will be held under the scrutiny of securities laws. More specifically, all information conveyed to investors at the time of purchase must include all material items concerning the issuance at hand.

B. Federally-Mandated Disclosure Must be Considered for Municipal Bond Offerings

A municipal bond issuance offering document, commonly referred to as an offering statement, shares many characteristics with general securities offerings. However, municipal offerings are not registered with the SEC and therefore do not technically need to comply with the

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1 *See generally* 17 C.F.R. § 240.10b-5 (2007).

2 *See* Basic, Inc. v. Levinson, 485 U.S. 224, 232 (1988) (quoting TSC Industries, Inc., v. Northway, Inc., 426 U.S. 438, 449 (1976)).

3 SEC Release No. 33,8591, 70 Fed. Reg. 44,721 (Dec. 1, 2005).

4 *See* 17 C.F.R. 230.159 (2007).

federal securities laws surrounding most corporate debt public offerings.[5] Regardless, it has long been the practice that the requirements of the Securities Act and the Exchange Act apply with equal force for municipal bonds.

Importantly, the SEC released Rule 15(c)(2)-12 under the Exchange Act in June of 1989, reinforcing the importance of disclosure for the sale of municipal bonds in the capital markets.[6] The advent of this rule further solidifies the industry practice that municipal bonds should follow and do follow similar rules as those governing corporate bonds. The provisions of Rule 15(c)(2)-12 effectively police underwriters so that any offering of municipal debt exceeding $1 million must comply with the rule's assorted mandates, unless the underwriter fits into a relatively narrow exception.[7] The rule is designed to "prevent fraudulent, deceptive, or manipulative acts or practices" by making sure that potential investors receive the most up-to-date version available of a preliminary offering statement when evaluating their purchase of a municipal security.[8] Furthermore, the rule requires underwriters to deliver material information about financial statements, defaults, defeasances, rating changes and modifications (among other items)[9] to a "recognized municipal securities information repository", the "appropriate state information depository" and sometimes the Municipal Securities Rulemaking Board.[10]

The rationale behind Rule 15(c)(2)-12 is that underwriters selling municipal securities, just as is the case with corporate securities, make "implicit or express purchase recommendations and…they should have a reasonable basis for making those recommendations." This rule underscores the fact that although municipal securities do not need to be registered with the SEC, they are subject to generalized antifraud provisions under federal law and their disclosure must be fulsome and on par with that disclosure required by federal securities laws governing corporate debt.

Besides the disclosure mandated under Rule 15(c)(2)-12, the same diligence that goes into the preparation of a registered prospectus is routinely used in the preparation of an offering statement to avoid fraud and other civil liability potential. Over the years, the practice has trended toward a higher level of detail and disclosure in these offering statements has increased, making the disclosure

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5 *See* ROBERT LAMB & STEPHEN RAPPAPORT, MUNICIPAL BONDS; THE COMPREHENSIVE REVIEW OF TAX EXEMPT SECURITIES AND PUBLIC FINANCE 287 (1st ed. 1980).

6 *See* 17 C.F.R. § 240.15c2-12 (2007).

7 *See id.* The exemptions for this section include (i) those issuances to 35 or fewer sophisticated investors who will not act as underwriters, (ii) those issuances of debt scheduled to mature in nine (9) months or fewer, (iii) those issuances which provide the holder with an option to redeem the securities every nine (9) months. *See id.* at § 240.15c2-12(d)(1).

8 *See id.* at § 240.15c2-12(d)(b)(2).

9 *See id.* at § 240.15c2-12(b)(5)(C).

10 *See generally id.* at § 240.15c2-12(d)(5)(A)-(C).

for a municipal bond issuance closely resemble that of a corporate debt issuance.[11] For municipal bonds, the practice has long been to print 'red herring' offering statements before the pricing of a deal to gauge investor interest and "to market the proposed issue prior to the date of sale."[12] The information contained in the offering statements for municipal bond issuances is information "known at the time of sale" or before the sale, under a Rule 159 analysis. Although Rule 159 does not specifically apply to municipal bonds (Rule 10b-5 does apply to municipal bonds) the underlying rationale of maintaining the integrity of the offering process holds true. For that reason, it has been a longstanding practice of municipal bond issuers to be wary of information, misinformation or lack of information contained in an offering statement (even in a 'red herring' version).

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11 *See* Lamb & Rappaport, *supra* note 25, at 288.

12 *See id.*