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Municipal Antifraud Liability Under the Federal Securities Laws upon Issuance of Tax-Exempt Industrial Development Bonds

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MUNICIPAL ANTIFRAUD LIABILITY UNDER THE FEDERAL SECURITIES LAWS UPON ISSUANCE OF TAX-EXEMPT INDUSTRIAL DEVELOPMENT BONDS

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Traditionally characterized as sound investments,[1] municipal bond issues increasingly are experiencing defaults.[2] One cause of these bond defaults, borrower insolvency, frequently results from the issuer's misrepresentation about the borrower's financial position.[3]

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1. Speer, *What Every Lawyer Should Know About Municipal Bonds*, 44 ILL. B.J. 146, 147 (1955) (municipal bonds rank second only to United States Government Bonds for security). *Accord* Peacock, *A Review of Municipal Securities and their Status Under the Federal Securities Laws as Amended by the Securities Acts Amendments of 1975*, 31 BUS. LAW. 2037, 2038 (1976); Schwarz, *Municipal Bonds and the Securities Laws: Do Investors Have an Implied Private Remedy?*, 7 SEC. REG. L.J. 119, 123 (1979).

2. *See, e.g.*, Bradford Sec. Processing Servs., Inc. v. County Fed. Sav. & Loan Ass'n, 474 F. Supp. 957, 960 (S.D.N.Y. 1979) (fraud by bond salesman before industrial development bond default); Scarfotti v. Bache & Co., 438 F. Supp. 199, 201 (S.D.N.Y. 1977) (private corporation default on industrial development bond debt service). *See also* Doty & Petersen, *The Federal Securities Laws and Transactions in Municipal Securities*, 71 NW. U.L. REV. 283, 329-33 (1976) (comparison of municipal and corporate defaults). *See generally* ADVISORY COMMITTEE ON INTERGOVERNMENTAL RELATIONS, CITY FINANCIAL EMERGENCIES: THE INTERGOVERNMENTAL DIMENSION 9-30 (1973) (discussion of past municipal bond defaults).

3. *E.g.*, *In re* New York Mun. Sec. Litig., [1980 Transfer Binder] Fed. Sec. L.

Tax-exempt industrial development bonds (IDB's),[4] similarly abused by parties to an IDB offering,[5] also experience delinquencies.[6] Given the current industrial development bond "mini-boom,"[7] municipal issuers should assess their potential liability for IDB default under the federal antifraud securities laws.[8] This Note examines the securi-

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Rep., (CCH) ¶ 97,258 (S.D.N.Y. 1980) (action by bond purchasers against New York City officials, banks and underwriting firms because of city's near financial collapse). *See* Casey & Smith, *A New Look at Municipal Bonds—Disclosure Responsibilities in the Municipal Bond Market*, 50 ST. JOHN'S L. REV. 639 (1976). *But see* Sykes, *Civil Liability of Public Officers Under Federal Securities Statutes for Municipal Bond Misrepresentations*, 2 URB. LAW. 219, 220 (1970) (misrepresentations by officials rarely occur).

4. The typical industrial development bond finances a municipality's purchase or construction of capital improvements for use by private enterprise. The governmental issuer leases the facility to a corporate borrower, which forwards lease payments to a trustee. The trustee disburses bond proceeds to facilitate construction and to finance the borrower's operations. The borrower's lease payments reduce outstanding bond principal and interest. A mortgage on the underlying real property secures the bond. Municipalities normally do not back an IDB with their full faith and credit or taxing authority. In many instances the issuer disclaims liability for borrower default and only oversees the trustee's management of cash flow. Upon expiration of the lease, the lessee may renew the lease or purchase the facility for a nominal sum. Otherwise, the facility reverts to the municipality. *See* Greenberg, *Municipal Securities: Some Basic Principles and Practices*, 9 URB. LAW. 338, 344 (1977). *See also* Abbey, *Municipal Industrial Development Bonds*, 19 VAND. L. REV. 25, 26 (1965).

A community and a corporation utilizing this financing method receive several benefits. An increased tax base enables the community to expand governmental services. The newly located company stimulates local employment and business investment. *See* S. BUCHER, IMPACT OF NEW INDUSTRIAL PLANTS: EIGHT CASE STUDIES 2 (1971). Because industrial development bonds are tax exempt, the corporate borrower benefits from the decrease in the cost of capital. *See generally* Note, *The Importance of Assessing Business Transactions for their Impact Upon the Tax-Exempt Status of Industrial Redevelopment Bonds*, 30 SYRACUSE L. REV. 705 (1979).

5. The parties principally involved with an industrial development bond offering are the borrower, the municipal issuer, the bond and corporate counsel, the project analyst, the underwriter (sometimes also acting as broker) and the bond trustee. KUTAK, ROCK & HUIE, RESOURCE MATERIALS FOR THE FUNDAMENTALS OF PUBLIC FINANCE 4 (1981).

6. *E.g.*, Bradford Sec. Processing Servs v. County Fed. Sav. & Loan Ass'n, 474 F. Supp. 957, 965 (S.D.N.Y. 1979) (securities brokerage and bond trustee failed to investigate and disclose IDB trading scheme by bond salesman); Franke v. Midwestern Okla. Dev. Auth., 428 F. Supp. 719 (W.D. Okla. 1976) (bond counsel omitted material facts in preparation of IDB legality opinion); SEC v. R.J. Allen & Assocs., 386 F. Supp. 866, 872 (S.D. Fla. 1974) (bond salesmen duped veterans by misrepresentation and bond substitution).

7. Address by Richard L Weill to the Public Securities Association, on *The Mini-Boom in Industrial Development Bonds* (Oct. 23, 1980).

8. Doty & Petersen, *supra* note 2, at 377. Although experts debate the question of

ties and tax implications of an IDB issuance. It then analyzes the constitutionality of municipal liability and the possible antifraud violations by a municipal issuer. Finally, it explores measures to reduce municipal liability and to strengthen the security of industrial development bonds.

I. THE SETTING

States and their political subdivisions frequently attempt to encourage economic growth and industrial concentration within their borders.[9] Industrial development bonds provide one means of encouraging industrial growth.[10] Although municipalities accrue economic benefits from IDB issuances,[11] they rarely back the bond with full faith and credit or taxing authority.[12] Instead, municipal disclaimers for any type of liability arising from an issuance are the norm.[13] In spite of this practice, municipal issuers may be subject to antifraud liability under certain circumstances.[14] The Securities Act

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whether sovereign immunity protects municipal government and its officials from investor suit, several commentators believe that it does not. *See, e.g.*, Borge, *Municipal Securities Offerings and the Need for Voluntary and Responsible Disclosures*, 3 CURRENT MUN. PROBS. 146 (1976). *See infra* notes 46-68 and accompanying text.

9. Note, *Legal Limitations on Public Inducements to Industrial Location*, 59 COLUM. L. REV. 618, 623 (1959). *See* GOODBODY & CO., INDUSTRIAL AID FINANCING 1 (1st ed. 1965).

10. From 1975 to 1980, small issue IDB sales increased over six-fold.

Small Issue Industrial Development Bond Sales

(in Thousands)

1975	1976	1977	1978	1979	1980
$1,343.3	$1,538.1	$2,282.6	$3,528.5	$7,140.0	$8,439.9

CONGRESSIONAL BUDGET OFFICE, SMALL ISSUE INDUSTRIAL DEVELOPMENT BONDS 71 (1981).

Many small IDB issues are placed privately and not reported to the Congressional Budget Office. The above figures are therefore estimated. *Id.* at 13.

11. GOODBODY & CO., *supra* note 9, at 39-40. *See supra* note 4.

12. If a municipality guaranteed an IDB with its full faith and credit, it would ultimately be accountable to aggrieved purchasers. *See* Address by SEC Commissioner Karmel, *Legislative Proposals Regarding IDB's*, [hereinafter cited as Karmel Address] *reprinted in* 182 PRACTICING LAW INSTITUTE: MUNICIPAL BONDS 227, 230 (1980). *Cf.* Abbey, *supra* note 4, at 26 (some municipalities *do* back IDB's with their full faith and credit.

13. *E.g.*, Scarfotti v. Bache & Co., 438 F. Supp. 199, 201 (S.D.N.Y. 1977) (the bond certificates patently disclaimed liability of the issuing authority and the state of New York). *See* Greenberg, *supra* note 4, at 344.

14. *See infra* notes 69-123 and accompanying text.

of 1933 (1933 Act),[15] the Securities Exchange Act of 1934 (1934 Exchange Act),[16] and their interplay with Internal Revenue Code (IRC) section 103[17] delineate the legal status of an IDB issuer.

II. THE FEDERAL SECURITIES LAWS AND INTERNAL REVENUE CODE SECTION 103

Municipal securities, under section 3(a) of the 1933 Act[18] and section 3(a)(12) of the 1934 Exchange Act,[19] are exempt from the registration and reporting requirements of the federal securities laws.[20]

Prior to 1975, "persons" subject to the 1934 Exchange Act's antifraud provisions, section 10(b)[21] and rule 10b-5,[22] did not include municipalities.[23] Although section 2(2) of the 1933 Act[24] includes

15. 15 U.S.C. §§ 77a-77aa (1976).

16. 15 U.S.C. §§ 78a-78jj (1976).

17. I.R.C. § 103 (1976).

18. 15 U.S.C. § 77c(a) (1976).

19. 15 U.S.C. § 78c(a)(12) (1976).

20. Note, *Securities Regulation: The Liability of Municipalities for State and Federal Securities Fraud in the Issuance of Industrial Development Bonds*, 30 OKLA. L. REV. 704, 712 (1977). Municipal officials, because of the enormous underwriting fees registration entails, actively lobbied Congress for the exemption. *See* Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 39 (1959).

21. 15 U.S.C. § 78j (1976) provides as follows:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) to use or employ, in connection with the purchase of sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

22. 17 C.F.R. § 240.10b-5 (1982) provides as follows:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

a) to employ any device, scheme, or artifice to defraud,

b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

23. 15 U.S.C. § 78c(a)(9) (1976).

24. 15 U.S.C. § 77b(2) (1976).

municipalities within the definition of "persons" liable for fraudulent securities transactions, courts disallow private actions brought under section 17(a),[25] of the 1933 antifraud Act.[26]

Woods v. Homes and Structures of Pittsburgh[27] illustrates the dilemma these provisions presented to aggrieved IDB investors. In *Woods*, the city of Pittsburgh, Kansas issued an IDB for the benefit of Homes and Structures.[28] The IDB was issued prior to the 1975 Exchange Act amendments, which rendered municipalities subject to antifraud liability. Approximately one year after bond distribution, Homes and Structures defaulted on its debt and lease payment obligations.[29] Because the corporate guarantors had vanished,[30] the investors sought relief against Pittsburgh under sections 10(b), 17(a) and rule 10b-5.[31] The *Woods* court dismissed the section 10(b) and rule 10b-5 claims, because Pittsburgh was not a "person" subject to 1934 Exchange Act antifraud liability.[32] The court also barred the

25. 15 U.S.C. § 77q(1) (1976). Section 17(a) employs language similar to section 10(b) and rule 10b-5, covering purchases and sales. Section 17(a), however, broadens its scope to security "offers." *Id.*

26. The denial of the section 17(a) private right of action is premised on the provision for such an action in sections 11 and 12(2) of the 1933 Act. These latter sections are broad enough in scope to cover any violation under 17(a). Reid v. Mann, 381 F. Supp. 525, 526 (N.D. Ill. 1974). *See, e.g.*, SEC v. Texas Gulf Sulphur, 401 F.2d 833, 867 (2d Cir. 1968) (en banc) (corporation and its officers subject to antifraud liability for illegal trading on information about an undisclosed ore discovery), *cert. denied*, 394 U.S. 976 (1969). *See also* McFarland v. Memorex, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,368 (N.D. Cal. 1980) (no implied remedy provided). *Contra* Newman v. Prior, 518 F.2d 97, 99 (4th Cir. 1975) (implied remedy provided). The majority view maintains that section 17(a) provides for only injunctive relief, or upon a showing of fraudulent intent, criminal liability. Landis, *Liability Sections of Securities Act*, 18 AM. ACCT. 330, 331 (1933).

27. 489 F. Supp. 1270 (D. Kan. 1980).

28. *Id.* at 1276. The revenue from the bond was to be used to construct a manufacturing facility in Pittsburgh. Homes and Structures leased the facility to build modular home components. The revenue from the lease of the land and the facility was to be used to pay the interest and principal to the bondholders. *Id.*

29. *Id.* at 1277.

30. *Id.*

31. *Id.*

32. *Id.* at 1282. The *Woods* court followed an analysis of the 1934 Exchange Act legislative history by Judge Owen. *See In re* New York City Mun. Sec. Litig., [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,258 (S.D.N.Y. 1980) (suit against city officials for not disclosing New York's precarious financial position upon issuance of general obligation bonds). *See also* Greenspan v. Crosbie, [1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,780 (S.D.N.Y. 1976) (dismissal of suit by purchaser of

section 17(a) cause of action, holding that private relief was unavailable thereunder.[33]

Because of widespread industrial development bond use,[34] in 1968 the Securities and Exchange Commission (SEC) promulgated rules 131 and 3b-5 under the 1933 and 1934 acts, respectively.[35] These rules identified IDB's as "separate securities," subject to the registration and reporting provisions of the securities laws.[36] In 1970, Congress rejected this extreme method of antifraud prevention[37] by amending section 3(a)(2) of the 1933 Act and section 3(a)(12) of the 1934 Exchange Act.[38] The amendments provide that tax-exempt industrial development bonds, meeting the requirements of IRC section 103,[39] are exempt from SEC registration and reporting.[40]

IRC section 103 excludes from a taxpayer's gross income any inter-

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corporate stock against the Providence of Newfoundland and Labrador and its government officials).

33. 489 F. Supp. at 1284-88.

34. Public industrial development bond sales rose from $504.5 million in 1966 to $1.56 billion in 1968. *See* THE BOND BUYER'S MUNICIPAL FINANCE STATISTICS, THE DAILY BOND BUYER (1979) [hereinafter cited as BOND BUYER].

35. Securities Act Release No. 4921 and Exchange Act Release No. 8388, [1968 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,592 (1968). The full text of Rule 131 can be found at 17 C.F.R. § 230.131 (1981). The full text of Rule 3b-5 can be found at 17 C.F.R. § 240.3b-5 (1982).

36. *Id. See also* Note, *Municipal Bonds—The Need for Disclosure*, 78 W. VA. L. REV. 391, 394 (1976).

37. A sharp decrease in IDB financing apparently prompted Congress to act. Although 1968 public placements totaled $1.56 billion, 1969 sales dropped to $24 million. BOND BUYER, *supra* note 34.

38. The amended acts were codified at 15 U.S.C. § 77c(a)(2) (1976) and 15 U.S.C. § 78c(a)(12) (1976).

39. I.R.C. § 103 (1976) provides in part:

2) Industrial development bond

For purposes of this subsection the term "industrial development bond" means any obligation—

A) which is issued as part of an issue all or a major portion of the proceeds of which are to used directly or indirectly in any trade or business carried on by any person who is not an exempt person (within the meaning of paragraph (3)), and

B) the payment of the principal or interest on which (under the terms of such obligation or any underlying arrangement) is, in whole or in major part—

i) secured by any interest in property used or to be used in a trade or business or in payments in respect of such property, or

ii) to be derived from payments in respect of property, or borrowed money, used or to be used in a trade or business.

40. 15 U.S.C. §§ 77c(a)(2), 78c(a)(12) (1976).

est received from federal, state and municipal obligations. It also exempts interest from industrial development bonds that finance community projects such as family housing, sports and convention halls, transportation and utility and pollution control outlets. Section 103(b)(5) additionally exempts IDB issues of less than $1 million; $10 million at the election of the issuer with Treasury Department authorization. Hence, IRC section 103 and the securities laws' industrial development bond provisions create an inescapable interplay between the tax and securities law provisions.[41]

The 1975 amendments to the securities laws revised section 3(a)(9) of the 1934 Exchange Act[42] to designate "government and political subdivisions" as "persons" subject to antifraud liability under section 10(b) and rule 10b-5.[43] Therefore, although IDB's are exempt from registration requirements,[44] bonds issued after the 1975 amendments expose the municipality to private actions under section 10(b) and rule 10b-5.[45]

III. THE CONSTITUTIONAL QUESTION

In recent municipal securities fraud proceedings, several tribunals discussed whether the tenth amendment[46] prohibits Congress from imposing antifraud liability upon municipal bond issuers.[47] The

41. For an excellent analysis of the section 103 effect on business decisions utilizing IDB's, see Note, *supra* note 4. *See also* Note, *supra* note 20, at 713-14.

42. 15 U.S.C. § 78c(a)(9) (1976).

43. The 1975 amendments were designed to prevent fraud and misrepresentation in the entire municipal securities industry. Municipal issuers are regulated indirectly through the creation of the Municipal Securities Rulemaking Board (MSRB) and the Municipal Finance Officers' Association (MFOA). The MSRB regulates municipal securities dealers while the MFOA guidelines suggest methods of disclosure for revenue bond issuers. *See* Dikeman, *Municipal Securities Rulemaking Board: A New Concept of Self-Regulation*, 29 VAND. L. REV. 903 (1976); Doty & Petersen, *supra* note 2, at 5.

44. The MSRB is not empowered to require registration of municipal security offerings before their sale. 15 U.S.C. § 78*o*-4(d)(1)-(2) (Supp. V 1975). Some commentators believe, however, that the SEC, under the 1975 amendments, may require certain disclosures after the sale. Doty & Petersen, *supra* note 2, at 300.

45. *E.g.*, Woods v. Homes and Structures, 489 F. Supp. 1270 (D. Kan. 1980). In *Woods*, section 10(b) and rule 10b-5 relief was denied because the IDB was issued prior to 1975. *See supra* notes 27-33 and accompanying text.

46. The tenth amendment provides: "The powers not delegated to the United States by the Constitution, nor prohibited by it to the states, are reserved to the states respectively, or to the people." U.S. CONST. amend. X.

47. *E.g.*, City of New York v. SEC, [1976 Transfer Binder] Fed. Sec. L. Rep.

Supreme Court's most definitive statement of municipal powers under the tenth amendment,[48] *National League of Cities v. Usery*,[49] provides guidance on this question.

In *National League of Cities*, the Court invalidated the extension of the Fair Labor Standards Act (FLSA) and its minimum wage and hour provisions to state employees.[50] The Court, balancing the importance of the provisions and their potential adverse effect on municipal budgets, held that the FLSA amendments interfered with the states' ability to furnish traditional[51] and essential government services.[52]

The rationale of this tenth amendment holding was thereafter extended to the municipal securities context[53] in *Philadelphia v. SEC*.[54] In an attempt to enjoin an SEC investigation, Philadelphia officials relied on *National League of Cities*, arguing that the SEC's presence would erode investor confidence.[55] This would raise the city's borrowing cost and impair the delivery of governmental services.[56] The *Philadelphia* court rejected the city's argument by reasoning that a preliminary investigation would not displace state services and would

(CCH) ¶ 95,667 (S.D.N.Y. 1976) (declaratory judgment action for a determination that SEC intervention violated tenth amendment). *See also* Note, *Federal Regulation of Municipal Securities: A Constitutional and Statutory Analysis*, 76 DUKE L.J. 1261, 1312 (1976).

48. Brady, The Constitutional Limitations Upon Federal Regulation of Municipal Issuers, 51 ST. JOHN'S L. REV. 565, 574 (1977).

49. 426 U.S. 833 (1976).

50. *Id.* at 852.

51. *Id.* at 845.

52. *Id.* The Court noted the severe strain that the FLSA wage and hour requirements placed on state budgets. These requirements forced the plaintiffs to curtail affirmative action police training programs and other governmental services. *Id.* at 846-47.

The Court distinguished Fry v. United States, 421 U.S. 542 (1975), which upheld the Nixon Administration's wage and price freeze. *Fry*, according to the Court, involved an emergency measure operating temporarily only. 426 U.S. at 852. The freeze did not displace state functions and, in fact, reduced state fiscal pressures. *Id.* at 853.

53. City of New York v. SEC, [1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,667 (S.D.N.Y. 1976) first raised this issue. *See supra* note 47 and accompanying text. It does not appear that there was a final disposition of the tenth amendment question.

54. 434 F. Supp. 281 (E.D. Pa. 1977), *appeal dismissed*, 434 U.S. 1003 (1978).

55. 434 F. Supp. at 283, 287.

56. *Id.* at 283.

not create the interference that city official feared.[57] Although the *Philadelphia* court did not address the "balancing approach" discussed in *National League of Cities*,[58] the federal interest in investor protection apparently superseded the minimal displacement of city functions.[59]

An industrial development bond issuance presents an additional argument against municipal immunity. By issuing an IDB, the municipality necessarily acts within a proprietary scope.[60] Municipal engagement in private enterprise, according to several high court decisions,[61] removes any sovereign immunity claim.[62] In *Woods v. Homes and Structures of Pittsburgh*,[63] the city of Pittsburgh, in its defense against fraud claimed immunity under the tenth amendment and the holding of *National League of Cities*.[64] The *Woods* court denied immunity, emphasizing that the corporation, rather than the city, received the primary benefits of the IDB.[65] Furthermore, the court found that antifraud enforcement would not displace city services,[66] and providing corporate capital was not a traditional governmental function.[67]

The *Woods* approach contains four tiers, each representing a bar to

57. *Id.* at 288. The *Philadelphia* court read *National League of Cities* as striking down federal law that usurped areas traditionally regulated by the states. *Id.* at 287. For support of this view, see Brady, *supra* note 48, at 574.

58. 426 U.S. at 856 (Blackmun, J., concurring). Justice Blackmun stated that federal legislation should mandate state compliance only when the federal government has a comparatively predominant interest. *Id.*

59. 434 F. Supp. at 288.

60. *See Note, Municipal Bonds and the Federal Securities Laws: The Results of Forty Years of Indirect Regulation*, 28 VAND. L. REV. 561, 564 (1975). *See also* Greenberg, *supra* note 4, at 344.

61. *E.g.*, New York v. United States, 326 U.S. 572 (1946) (state sales of mineral water not exempt from 1932 Revenue Act); United States v. California, 297 U.S. 175 (1936) (Federal Safety Appliance Act applicable to state-operated railway); South Carolina v. United States, 199 U.S. 437 (1905) (upheld federal license tax on state-established liquor dispensaries).

62. Brady, *supra* note 48, at 588.

63. 489 F. Supp. 1270 (D. Kan. 1980). *See supra* notes 27-33 and accompanying text.

64. 489 F. Supp. at 1296.

65. *Id.* at 1297.

66. *Id.*

67. *Id.* at 1296. The *Woods* court also relied on Amersbach v. City of Cleveland, 598 F.2d 1033, 1037 (6th Cir. 1979), to define characteristics of public functions. *Amersbach* maintains that community benefit, public service and the role of the gov-

the municipal claim of tenth amendment immunity. First, IDB's are proprietary in nature. Second, relief for defrauded investors does not interfere with city functions. Third, issuing an IDB is not an essential government activity. Fourth, investor protection is paramount.[68] A constitutional defense based upon the tenth amendment, therefore, will not protect a municipality charged with liability arising from an IDB issuance.

IV. Municipal Liability Under the Securities Laws Antifraud Provisions

An aggrieved industrial development bond investor who possesses substantive evidence of issuer fraud or misrepresentation may seek relief against the municipality as a principal perpetrator or as an aider and abettor.[69] Additionally, he may attempt to posit a remedy upon the agency principle of respondeat superior.[70]

A. Liability of the Issuer as a Principal

An IDB purchaser who relies on the municipality's false or misleading representations about the bond issuance may seek relief against the municipality under section 10(b) and rule 10b-5.[71] The first judicial response to the issue of municipal liability for securities fraud was *Thiele v. Shields*.[72]

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ernment as the instigator and most capable body to furnish the service, are the primary characteristics of public functions. 598 F.2d at 1037.

68. 489 F. Supp. at 1296-97. The *Woods* court also noted that municipal adherence to the antifraud laws would benefit bond purchasers and the city's work force, who might be employees of the corporate borrower. *Id.* at 1297.

69. *See, e.g.*, Rolf v. Blyth, Eastman, Dillon & Co., 570 F.2d 38 (2d Cir. 1978) (aider and abettor theory used to find brokerage firms liable for factual misrepresentation by an employee). The same theory could be applied to municipalities that do not verify the information supplied by the bond counsel. *See infra* notes 80-104 and accompanying text.

70. *See* Weill, *Securities Laws Issues in Industrial Development and Pollution Control Financing* in 113 Practicing Law Institute: Industrial Development and Pollution Control Financing 502, 510 (1977).

71. Although the SEC frequently learns about insolvencies of IDB financed enterprises, Karmel Address, *supra* note 12, at 240, no plaintiff has successfully attacked a municipality for fraudulent conduct in connection with an industrial development bond issuance. Note, *supra* note 20, at 718. *See also* Sykes, *supra* note 3, at 219.

72. 131 F. Supp. 416 (S.D.N.Y. 1955). The *Shields* litigation encompassed six suits, none of which made a final determination on the merits. *E.g.*, International Ladies' Garment Workers' Union v. Shields & Co., 209 F. Supp. 145 (S.D.N.Y. 1962);

In *Thiele*, plaintiffs, who purchased Bellevue, Nebraska Bridge Commission bonds, accused the Commission of fraudulently misrepresenting the estimated vehicular traffic in the bond-offering brochure.[73] Judge Kaufman, for the *Thiele* court, swept aside the notion that municipal officials fell outside the scope of "persons" subject to the provisions of sections 10(b) and 17(a).[74] He recognized, however, the municipal exemption from section 12(2) of the 1933 Act.[75] He also noted that section 12(2) imposed antifraud liability unless the security offeror could prove that the misrepresentation was negligent, rather than intentional.[76] Finally, Judge Kaufman observed that negligent misrepresentations were not expressly proscribed by sections 17(a) and 10(b).[77] Given the section 12(2) negligence defense, he held that municipal officials were not culpable unless plaintiffs proved an "intentional or knowing" misrepresentation.[78]

In order to obtain relief against the issuer as principal under section 10(b) and rule 10b-5, the defrauded IDB investor must demonstrate that the municipality, intentionally perpetrated a fraud, either orally, in an offering circular, or in written advertisements. Under 10b-5 any intentional omission of this kind will render the municipality liable.[79]

B. The Municipality as an Aider and Abettor

Bond counsel, the underwriter, the broker-dealer, the bond trustee, the corporate borrower and the municipal issuer are indispensable

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Thiele v. Shields, 131 F. Supp. 416 (S.D.N.Y. 1955); Greenwhich Sav. Bank v. Shields, 131 F. Supp. 368 (S.D.N.Y. 1955); Baron v. Shields, 131 F. Supp. 370 (S.D.N.Y. 1954); Connecticut Mut. Life Ins. Co. v. Shields, 131 F. Supp. 363 (S.D.N.Y. 1954); Citizens Casualty Co. v. Shields, [1952-1956 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,683 (S.D.N.Y. 1954).

73. 131 F. Supp. at 417.

74. *Id.* at 419-20. Judge Kaufman noted that Congress intended to hold liable municipal officers who intentionally misrepresented a fact about a bond, even though municipal officials are not liable for failure to prove that they exercised reasonable care in investigating the truth of a representation. *Id.*

75. *Id.* at 419.

76. *Id. See* 15 U.S.C. § 77*l*(2) (1976).

77. 131 F. Supp. at 419.

78. *Id.* at 420.

79. *See generally* Doty & Petersen, *supra* note 2, at 368.

parties to an IDB issuance.[80] After a determination of project feasibility, each party benefits from bond distribution.[81] The dealer earns sales commissions. The borrower, in many instances, depends on the bond to finance delayed capital expenditures for initial projects of operational improvements.[82] The municipality desires to attract or maintain the borrower's operation, to accrue tax revenue and to increase local employment.[83] The remaining parties receive their fees directly from bond proceeds.[84] These motives, individually or in the aggregate, might lead to placement of bond issues through false or misleading statements. As is commonly done in other securities fraud litigation,[85] a defrauded purchaser suing a principal perpetrator may join the IDB issuer as an aider and abettor.[86] *Brennan v. Midwestern United Life Insurance Co.*[87] illustrates the liability courts

80. KUTAK, ROCK & HUIE, RESOURCE MATERIALS FOR THE FUNDAMENTALS OF PUBLIC FINANCE 4 (1981).

81. Interview with spokesman from Goldman, Sachs & Co., in St. Louis, Missouri (Feb. 12, 1981). The determination of project feasibility alone requires large expenditures to determine if financial, architectural, operational and market projections are accurate. Interview with the Executive Director of the St. Louis County Development Authority, in St. Louis, Missouri (Sept. 23, 1981).

82. Interview with the Executive Director of the St. Louis County Development Authority, in St. Louis, Missouri (Sept. 23, 1981).

83. GOODBODY & Co., *supra* note 9, at 39-40.

84. Treas. Reg. § 1.103-13 (1979). These fees are defined as "issuing expenses." *Id.*

85. *E.g., In re* Equity Funding Corp. of Am. Sec. Litig., 416 F. Supp. 161, 179-80 (C.D. Cal. 1976) (insurance company fraud by falsely reporting earnings growth to raise stock trading prices); Pettit v. American Stock Exch., 217 F. Supp. 21, 28 (S.D.N.Y. 1963) (aiding and abetting culpability particularly proper where defendants owe special duty to plaintiffs); SEC v. Timetrust, Inc., 28 F. Supp. 34, 43 (N.D. Cal. 1939) (injunction is one remedy for aiding and abetting securities law violation). *See* Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification and Contribution*, 120 U. PA. L. REV. 597 (1972).

86. One definition of "aider and abettor" is generally used in criminal proceedings. "Whoever aids, abets, counsels, commands, induces or procures the commission of a crime is punishable as a principal. In order to aid or abet the commission of a crime a person must associate himself with the criminal venture, participate in it, and try to make it succeed." SEVENTH CIRCUIT JUDICIAL CONFERENCE COMMITTEE ON JURY INSTRUCTIONS IN FEDERAL CRIMINAL CASES, MANUAL ON JURY INSTRUCTIONS IN FEDERAL CRIMINAL CASES, *published in* 33 F.R.D. 523, 544 (1963). Although this definition refers to criminal activity, the concept can apply in civil or criminal securities fraud litigation.

87. 259 F. Supp. 673 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

place upon aiders and abettors in the securities fraud context.

In *Brennan*, plaintiffs alleged that Midwestern's officers and directors, with intent to profit personally, aided and abetted a brokerage firm by concealing the firm's improper activities.[88] The *Brennan* court stated that section 10(b) and rule 10b-5 could render the defendants culpable if Midwestern possessed knowledge by virtue of a "special relationship" with its investors, which resulted in a duty to disclose.[89] The Supreme Court took the *Brennan* decision[90] one step further. In *Ernst & Ernst v. Hochfelder*[91] the Court decided what standard of intent section 10(b) and rule 10b-5 required to attach aiding and abetting culpability.

In *Hochfelder*, plaintiffs alleged that Ernst & Ernst, a public accounting firm, aided and abetted a fraud perpetrated by a brokerage firm's president.[92] Plaintiffs premised their argument on defendant's improper audits of the brokerage firm.[93] The *Hochfelder* court held that section 10(b) and rule 10b-5 liability required the plaintiff prove defendant's "scienter," and not merely negligent conduct.[94] The Supreme Court refrained, however, from deciding whether "reckless" conduct could result in liability under these provisions.[95] At least one court has since implied that proof of recklessness would suffice.[96]

88. 259 F. Supp. at 675.

89. *Id.* at 681-82. In the securities trading context, the Supreme Court further defined a duty to disclose under section 10(b) and rule 10b-5. This duty, according to the Court, arises because of a "fiduciary or similar relation of trust." Chiarella v. United States, 445 U.S. 222, 228 (1980). *See generally* Comment, *Duty to Disclose Inside Information Arises from a Fiduciary or Special Relation between Parties to a Securities Transaction*, 58 WASH. U.L.Q. 1013 (1980).

90. Commentators disagree on whether *Brennan* requires the defendant aider and abettor to receive a personal benefit as a prerequisite to liability. Note, *supra* note 20, at 721-22, supports the requirement of a personal benefit because the *Brennan* defendants profited from their fraud through increased stock sales. *But see* Ruder, *supra* note 85, at 628. Adoption of the first position, in the IDB context, would require the plaintiff to allege facts which prove the municipality's profit.

91. 425 U.S. 185 (1976).

92. *Id.* at 190.

93. *Id.*

94. *Id.* at 205. The Court, strictly construing the 10(b) and 10b-5 language, stated that these provisions required a mental state embracing an intent to deceive or defraud. *Id.* at 194 n.12.

95. *Id.* at 214.

96. *See, e.g., In re* Clinton Oil Co. Sec. Litig., [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,015 (D. Kan. 1977) (the board of directors' reckless disregard of the shareholder interests would meet the *Hochfelder* standard).

It is inconsistent to predicate corporate liability upon a standard of "scienter"[97] while imposing municipal liability upon a standard of recklessness.[98] Both entities owe integrity and probing inquiry to the investing public. The corporation and its officials, however, normally possess greater expertise in the financial area than municipalities do.[99] Furthermore, corporate officers are the actual financial transactors, while municipal officials are essentially aligned with those receiving the most direct benefit from the IDB issuance.[100]

Under *Brennan v. Midwestern United Life Insurance*[101] an IDB purchaser must additionally demonstrate the issuer's knowledge of the principal's fraudulent activity and affirmative concealment when a duty to disclose exists.[102] Additionally, under *Ernst & Ernst v. Hochfelder*,[103] section 10(b) and rule 10b-5 liability will attach on a municipal aider and abettor only upon proof of intent to defraud.[104]

C. Municipal Liability on a Respondeat Superior Theory

Principal liability of a party to an IDB issuance is arguably imputable to a municipality.[105] Liability would be based upon the agency theory of respondeat superior. Under this theory, the party must be an agent of the municipal issuer[106] and must violate an antifraud provision while acting within the realm of the issuer's authority.[107]

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97. Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). *See supra* notes 91-96 and accompanying text.

98. *See* Comment, *Liability of Municipal Officials for Misrepresentations Concerning Municipal Securities: Should the Corporate Standard be Applied?*, 73 NW. U.L. REV. 137, 156 (1978). Other commentators, however, believe that a standard of recklessness for involved officials would encourage honest investigation. *See, e.g.*, Doty & Petersen, *supra* note 2, at 370-89.

99. Note, *supra* note 47, at 1286.

100. *Id.* at 1288.

101. 259 F. Supp. 673 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

102. 259 F. Supp. at 681-82, 684. *See generally* Note, *supra* note 20, at 717-22.

103. 425 U.S. 185 (1975).

104. *Id.* at 193.

105. For a general discussion of the municipality as a principal, see *supra* text accompanying notes 71-79.

106. RESTATEMENT (SECOND) OF AGENCY § 1.1 (1957) provides: "Agency is the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act."

107. *Id.* § 161.

Additionally, the culpable conduct must occur while the agent was performing his duties[108] for the issuer.[109] *Shores v. Sklar*,[110] an action against an industrial development bond counselor, lends itself well to respondeat superior analysis.

In *Shores*, the bond counselor violated section 10(b) and rule 10b-5 by misstating numerous facts in an offering circular.[111] The borrower, unable to fulfill its lease obligation, defaulted on debt service. The guarantors' assets similarly were unable to provide debt service.[112] Plaintiff, because he had not read the circular, sued Sklar on a fraud-on-the-market theory[113] to establish the proximate cause of his injury.[114] Plaintiff's argument, which the court upheld, was that but for the circular's omissions and inaccuracies, the IDB's would not have been marketable.[115]

The *Shores* rationale arguably could be extended. Under it, a plaintiff might allege that the bond counselor prepared the offering brochure under the issuer's authority and that preparation of the brochure was a normative duty the counselor owed the municipality.[116] Consequently, an agency relationship arose. The municipality, therefore, would be vicariously liable for its agent's antifraud violations.

Imposition of vicarious liability upon a municipality for the fraudulent conduct of another issuing party is problematic. Respondeat superior recovery would depend on the advocate's ability to prove that the issuer in fact "controlled" the actual perpetrator.[117] Success

108. *Id.* §§ 258, 261.

109. *See id.* § 257.

110. 610 F.2d 235 (5th Cir. 1980).

111 *Id.* at 237-38. Specifically, plaintiff accused the bond counselor of failing to disclose that the principal construction firm was defending several suits and that the firm made improper payments to the borrower to obtain the contract. *Id.* at 238.

112. *Id.*

113. *Id.* at 239.

114. *Id.* The fraud-on-the-market theory relies on the market to utilize all available information to establish the security's price. As the market relies on the available information misrepresentations or omissions can affect the price selected for an individual security. *Id.* at 240.

115. *Id.* at 239.

116. *E.g.*, Franke v. Midwestern Okla. Dev. Auth., 428 F. Supp. 719 (W.D. Okla. 1976) (investor suit against the law firms retained by the municipality to draft IDB legality opinion).

117. One pragmatic argument in support of this notion is that in many jurisdictions, the issuing authority decides who is qualified to serve as the borrower's bond

of this argument normally occurs in the employer-employee context.[118] With an industrial development bond, however, there is comparatively little nexus between the offering parties, unless conspiracy and aiding and abetting liability can be shown. It is doubtful therefore that a court would accept the "control" argument to impose vicarious liability on an issuing municipality.[119] Furthermore, it makes

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counsel. Interview with the Executive Director of the St. Louis County Development Authority, in St. Louis, Missouri (Sept. 23, 1981).

The Securities Act of 1933 and the 1934 Exchange Act codify a limited version of the common law doctrine of respondeat superior. Section 20(a), the "controlling person" provision of the 1934 Act, provides as follows:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, *unless the controlling person acted in good faith* and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 U.S.C. § 78t (1976) (emphasis added). Courts and commentators differ on whether section 20(a), in the securities context, expands or supplants the respondeat superior doctrine. Given the good faith defense that the section provides, one can forcefully argue that it displaces the strict liability common law concept. *E.g.*, Kamen & Co. v. Paul H. Aschkar & Co., 382 F.2d 689, 696-700, (9th Cir. 1967) (section 20(a), not respondeat superior, controls vicarious liability), *cert. granted*, 390 U.S. 942 (1968), *cert. dismissed*, 393 U.S. 801 (1969); Gordon v. Burr, 366 F. Supp. 156, 168 (S.D.N.Y. 1973) (action against corporate president for sale of stock through fraudulent misrepresentations, Section 20(a) controls); SEC v. Lum's, Inc., 365 F. Supp. 1046, 1063 (S.D.N.Y.. 1973) (statutory good faith and not respondeat superior is the standard to determine liability of a broker for actions by an employee).

Some courts, however, believe that section 20(a) expands the respondeat superior doctrine. *E.g.*, Marbury Management, Inc. v. Kohn, 629 F.2d 705, 712 (2d Cir. 1980) (employee's misrepresentation about status as investment analyst held actionable against brokerage); Rolf v. Blyth, Eastman, Dillon & Co., 570 F.2d 38, 43 (2d Cir. 1978) (broker liable for an employee's mishandling of an investment portfolio); Holloway v. Howerdd, 536 F.2d 690, 694-95 (6th Cir. 1976) (brokerage firm liable if investors do not know that the employee is acting outside of the firm).

Whether section 20(a) expands or restricts the doctrine of respondeat superior, it would nevertheless be improbable for a court to conclude that a municipality met the 20(a) standard of control for all of the parties in an IDB issuance. *See* Zweig v. Hearst Corp., 521 F.2d 1129, 1132 (9th Cir. 1975) (action against publisher for financial columnist's incorrect evaluation of company, good faith defense shown). For an excellent discussion of section 20(a) liability, see Note, *The Burden of Control: Derivative Liability under Section 20(a) of the Securities Exchange Act of 1934*, 48 N.Y.U. L. REV. 1019, 1021-25 (1973) (control can only be shown where the allegedly controlling person has actual control over the activities or entity which the principal perpetrator operated).

118. *See supra* note 117.

119. One court, in dictum, advocated issuer liability when plaintiff sued bond counsel but did not join the municipality. SEC v. Haswell, [1977 Transfer Binder]

little sense to require proof of "scienter"[120] for principal and aiding and abetting antifraud liability[121] while allowing a strict liability standard in respondeat superior cases.

Holding municipal issuers liable for negligent misstatements or under a respondeat superior standard would be a disservice to the general public. Law that would subject issuers to securities fraud liability for less than "intentional or knowing" misrepresentations could deter creative municipal finance programs and public service activities.[122] This would not be a wise policy choice and would do little to advance IDB investor protection.[123]

V. RECOMMENDATIONS FOR REFORM

An industrial development bond institutional or individual investor[124] must have comprehensive, accurate and independently verified data about the bond issue and its offering parties.[125] Debate arises,

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Fed. Sec. L. Rep. (CCH) ¶ 97,156 (W.D. Okla. 1977) (issuing authority might be liable if bond counsel's limited involvement precluded antifraud liability).

See also In re Walston & Co. and Harrington, [1966-1967 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,474 (1967), where an affirmative duty was placed on a brokerage to investigate a promoter's ability to service real estate bonds. *Id.* at 82,944-45. This duty arguably could be extended to a municipality to determine whether all offering parties are of the integrity to prevent an antifraud violation. *See generally* Sykes, *supra* note 3, at 233.

120. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976).

121. *See supra* notes 69-104 and accompanying text.

122. Note, *supra* note 47, at 1286. At least two commentators believe that municipal officials should be immune from liability unless the aggrieved party can prove "active fraud on the official's part." *Id.* at 1288. *See* Comment, *supra* note 98, at 156. Any other policy would deter "efficient, unencumbered government." *Id.* at 153. *See also* Glazer, *Is the Litigation Explosion Good for the U.S.?*, Wall St. J., Oct. 21, 1981, at 26, col. 5 (Book Review of J. LIEBERMAN, THE LITIGIOUS SOCIETY).

123. *See generally* Note, *supra* note 47, at 1286.

124. A great many IDB's are privately placed. With such issues, there are usually restrictions on bond sales to individuals. The institutional investor can usually sell part of an issue to another financial institution. This is tantamount to "participation lending" in the commercial banking context. Interview with the Executive Director of the St. Louis County Development Authority, in St. Louis, Missouri (Sept. 23, 1981). An institutional investor in a private placement would therefore treat the investment like a commercial loan and use many established investigative procedures. *Id. See* L. MOAK & A. HILLHOUSE, CONCEPTS AND PRACTICES IN LOCAL GOVERNMENT FINANCE 326 (1975).

125. Hellige, *Industrial Development Bonds: The Disclosure Dilemma*, 6 J. CORP. L. 291, 297 (1981).

however, about the feasibility of proposed disclosure measures.[126]

Initially, the SEC and various senators proposed federal legislation that would subject IDB's to the full registration and reporting requirements of the federal securities laws.[127] This legislation, however, would result in enormous administrative costs at the federal and local levels.[128]

Another proposal places the issuing, investigative and review procedures upon state securities commissions.[129] Given current state fiscal pressures and the difficulty of monitoring hundreds of bond issues in a particular area, states would probably not accept this task.[130]

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126. *Id.* at 310. *See generally* Currier, *Mandating Disclosures in Municipal Securities Issues: Proposed New York Legislation*, 8 FORDHAM URB. L.J. 67, 78 (1979).

127. The SEC proposed Rule 131 under the Securities Act of 1933 and Rule 3b-5 under the Exchange Act of 1934, which were adopted in 1968. Securities Act Release No. 4921 and Exchange Act Release No. 8388 [1968 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,592 (1968). For a discussion of these acts, see Note, *supra* note 36.

Senator Eagleton sponsored S. 2574, 94th Cong., 1st Sess., 121 CONG. REC. 33907 (1975), which required industrial development bonds to comply with the same registration and disclosure procedures as corporate securities. Senators Proxmire, Williams and Javits sponsored S. 2339, 95th Cong., 1st Sess., 123 CONG. REC. 38236 (1977), which required limited disclosure from industrial development bond issuers. The SEC, in 1978, introduced the Industrial Development Bond Act to obtain disclosure from IDB offerors. S. 3323, 95th Cong., 2d Sess., 124 CONG. REC. 21632 (1978). This Act places an IDB borrower into alignment with a corporate securities issuer. It defines "issuer" as the enterprise which is receiving bond proceeds and is not responsible for its repayment. By amending section 2(4) and section 3(a)(2) of the 1933 Act, requiring securities registration, the Industrial Development Bond Act,if enacted, would subject IDB's to the 1933 Act and the 1934 Exchange Act registration and reporting provisions. *See* Currier, *supra* note 126, at 84.

128. Due to the large underwriting and legal fees registration entails, the Eagleton bill, S. 2574, contravenes cost efficiencies associated with IDB financing. It would also greatly increase the SEC's workload. This measure, therefore, received little support. The disclosure sought by the Proxmire bill, S. 2339, focused on the municipal issuer, rather than the corporate borrower. Because the borrower is ultimately obligated to repay the IDB, this proposal was also inappropriate to meet investors' needs. Hellige, *supra* note 125, at 310-13. The SEC proposal, S. 3323, has the same cost disadvantage as the Eagleton bill.

129. Note, *supra* note 20, at 724. The author suggests that states pledge their full faith and credit as a guaranty of payment in the event of IDB default. *Id.* It is doubtful, however, that states would expose themselves to such liability.

130. Some states, for example Oklahoma, Mississippi, Kentucky, Pennsylvania, Massachsetts, Connecticut and California, have established state industrial development authorities. *See* Note, *supra* note 20, at 708. If such states are willing to accept the administrative task of issuing IDB's, arguably they could implement state securities laws to regulate IDB disclosure and reporting.

A third method to increase investor protection and to reduce municipal liability would place the onus on the issuer.[131] Other than the borrower, the municipality is the primary beneficiary of the IDB[132] and, with the trustee, is in the best position to oversee a particular bond issue.[133] A municipal investigation would focus upon the financial stability and business integrity of the corporate borrower,[134] the party actually accountable for debt service.[135] While municipalities currently assess the borrower's financial position, the degree and thoroughness of these assessments vary widely. To promote uniformity, independent auditors[136] could be utilized to analyze completely the past and present financial status of the borrower.[137] Industry forecasts and product market conditions could be qualitatively and quantitatively evaluated. Management plans and objectives for future corporate revenues and earnings could be realistically assessed to determine whether the obligors will fulfill their borrowing responsibilities.[138] This information, in all IDB issues, would be compiled

131. Interview with Spokesman from Goldman, Sachs & Co., in St. Louis, Missouri (Feb. 12, 1981). This proposal is apparently supported by the brokerage industry and some issuing authorities. *Id.* Interview with the Executive Director of the St. Louis County Development Authority, in St. Louis, Missouri (Sept. 23, 1981).

132. GOODBODY & Co., *supra* note 9, at 39-40; Currier, *supra* note 126, at 78. *See supra* note 4.

133. The municipality, as the issuer, should be in close contact with the offering parties. Interview with spokesman from Goldman, Sachs & Co., in St. Louis, Misssouri (Feb. 12 1981).

134. Note, *supra* note 36, at 401.

135. *See* Hellige, *supra* note 125, at 314. Additionally, proper investigation warrants a review of the bond underwriters and brokers. This is partially accomplished by the Municipal Securities Rulemaking Board, a creation of the 1975 Exchange Act Amendment. 15 U.S.C. § 78*o*-4(b)(1) (1976). *See supra* notes 43-44.

At least two commentators believe that in municipal general obligation offerings, underwriters, brokers, bond counsel, accountants and the issuer should investigate each other to provide appropriate public disclosure. Doty & Petersen, *supra* note 2, at 389.

136. The larger issuing authorities tend to conduct their own, independent borrower evaluation. Interview with the Executive Director of the St. Louis County Development Authority, in St. Louis, Missouri (Sept. 23, 1981).

137. This evaluation should encompass a five-year survey of assets, liabilities, debt structure, return on investment, return on assets and annual changes in financial position. There also should be a continual review of problems involving litigation, arbitration and labor relations. *See generally* Casey & Smith, *supra* note 3, at 645 n.22.

138. The Securities and Exchange Commission, subject to "safe-harbor" guidelines set forth in Rules 175 and 3b-6, allows corporate projections of revenues, earn-

in a comprehensive offering memorandum with an accuracy endorsement by all offering parties.[139] Finally, periodic reviews and reporting would continue while the bond remained outstanding. Indications of borrower insolvency should prompt the issuer, and particularly the trustee, to attempt to reduce the likelihood of default. This could be accomplished by accelerating all payments due under the bond or restructuring the borrower's financial and operational position. All such efforts should ultimately enable the borrower to satisfy timely the debt obligation.[140]

VI. CONCLUSION

Soaring interest rates motivate corporations to seek tax-exempt financing. Urban unemployment and suburban population growth intensify municipal efforts of industrial inducement. These factors lead to increased IDB use. Congress, by exempting tax-exempt industrial development bonds from SEC registration and reporting, placed the responsibility for regulation on local authorities. Municipalities must therefore act to reduce their liability and to protect their citizens who invest on IDB's. Certainly, an industrial development bond purchaser merits the same protections afforded a corporate securities investor.[141]

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ings and overall growth. D. RATNER, SECURITIES REGULATION: MATERIALS FOR A BASIC COURSE 724 (2nd ed. 1980).

Market factors, such as industry position and competition, should be evaluated. Company operational variables, such as order backlog, supply and demand segment dependence and seasonal variations, should be investigated. Note, *supra* note 36, at 407.

139. This is in effect a "red-herring Preliminary Official Statement." This statement is admittedly a comprehensive document; its information should be disclosed equally to institutional and individual investors. Interview with the Executive Director of the St. Louis County Development Authority, in St. Louis, Missouri (Sept. 23, 1981).

140. Periodic reporting to the issuer would allow immediate remedial action should the parties discover the borrower's financial difficulties. Certainly a debt restructuring or a management overhaul is preferable to complete default. *Id.* Admittedly, elected officials have time and skill constraints on their ability to reevaluate the borrower. In most issuing municipalities, members of the bond authority are fully occupied by their primary professions. This mandates expert independent review. *See* Note, *supra* note 47, at 1286-87.

141. *See* Note, *supra* note 36, at 410.

COMMENTS