# Buying Dirt District Bonds for a Bank's Own Account: A Cautionary Tale from One Colorado District Court

BY JOHN A. ECKSTEIN, FAIRFIELD AND WOODS, P.C.

Community banks in Colorado are presented with opportunities to purchase for their own accounts the tax exempt debt obligations of limited purpose political subdivisions known as "special districts." The proceeds of these borrowings are often used by newly-formed districts to reimburse or pay the original developers of real estate located within the districts for the expenses of construction of basic infrastructure such as water, sewer, bridges, gas and electricity distribution, streets and gutters, curbs and sidewalks, landscaping and parks. On January 5, 2017, a trial court in western Colorado issued a decision with regard to some defaulted bonds originally issued by a special district located in suburban Denver which were purchased for investment by four small banks. The decision provides several points to ponder for bankers when considering the possible purchase of privately placed special district bonds.

On March 6, 2006, a Colorado bank and three affiliated banks purchased for their own accounts $4.130 million of unrated general obligation bonds from underwriter Stifel Nicolaus immediately after their original issuance by Lincoln Creek Metropolitan District, a newly formed special district encompassing 62 acres of raw land located in Arapahoe County, near Parker, Colorado. The infrastructure was completed with the bond proceeds, but almost no residences were constructed, the tax base remained low, and the bonds went into default in early 2008. The banks sued Stifel Nicolaus and the developers for rescission under the Colorado state securities laws, asserting that the defendants failed to disclose certain material facts in the district's disclosure documents and that other facts disclosed were materially false and misleading. The original complaint was filed in [October 2008]; the case resulted in a 10-day trial to the court only in April 2016 and a subsequent decision in 2017 in favor of the defendants.

The 2017 written decision is of interest to lawyers because very few civil actions under the Colorado Securities Act ever proceed completely through trial. However, there also are in the judge's determinations business points to be pondered by banks when performing the necessary investigation and making the decision to purchase or not purchase such securities. First, and perhaps of most importance, the court determined that the banks and their investment officers were sophisticated, knowledgeable, experienced investors and thus the court considered the materiality of facts in light of these higher capabilities of these investors. Second, the court examined the "total mix" of information available to the banks, which, mostly because of proactive diligence activities of the banks' investment officers, resulted in the banks having additional information well beyond that provided in the disclosure documents, information which the court determined was material to the investment decision (although the offering documents implied that any such information could be unreliable and the court determined that some of this additional information obtained by the banks was incorrect). Third, the court determined that, despite the statement in the disclosure documents and in the developers' responses to diligence inquiries of investment officers, that $3.3 million of additional financing was available to the developers (which in fact was unavailable when the bonds were sold) which statement the court found to be a clear misrepresentation, such an omission did not create a substantial likelihood that, under all the circumstances, the omission "would have assumed actual significance in the deliberations of a reasonable investor."

The Colorado securities fraud rescission statute did not require the banks to prove reliance, intent, or causation, as is usually the situation under the federal securities fraud decisions interpreting SEC Rule 10b-5. However, given the court's approach to this particular bond default, banks still are faced with a bit of a Hobson's choice when buying high yield securities in Colorado: if they actively and deeply investigate and then invest in debt which fails, their deeper knowledge gained can be used to discount the importance of omissions by sellers of particular facts which the banks never learn, but, on the other hand, if they do not investigate enough, and still invest, their ignorance may result in investing in more bonds which fail. If anything, this decision is another reason why private placements of unrated general obligation dirt district bonds must still be approached with extreme caution. (Note: John A. Eckstein was an expert witness in this case testifying on behalf of the plaintiff banks on Colorado's sovereign immunity law as applied to the developers.)

John A. Eckstein focuses on the general representation of technology-based companies and venture capital funds, investors, investment bankers, financial advisors and financial institutions. He works often with complex legal structures in entity and project financings; however, lately he has often represented private business owners in the exit sale of their companies. He can be reached at jeckstein@fwlaw.com or (303) 894-4448.