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Federal Appeals Court Rules Municipal Bond Insurer Lacks Standing for Securities Fraud Claims

On September 18, the U.S. Court of Appeals for the 11th Circuit, in a case closely watched by bond insurers, other credit enhancers and issuers, conduit borrowers, and underwriters of insured or credit-enhanced debt, ruled that a bond insurer lacks standing to bring securities fraud claims in connection with the information on which it bases its decision to insure a municipal bond issue. The appellate court's opinion, which vacated the same judicial panel's May 31, 2006 opinion in the same case that the bond insurer *did* have standing, seems to be based on unusual or misunderstood facts, and is unlikely to be the last word in this controversy.

The litigation, *Financial Security Assurance, Inc. v. Stephens, Inc.,* arises from a 1998 solid waste bond issue that was insured by FSA. Shortly after the bonds were issued, the issuer revised its budget and cash flow analysis and amended its contract with a key waste hauler in a manner that reduced the tipping fee and relieved the waste hauler of its tonnage guarantee. The issuer subsequently was unable to service the debt on the insured bonds, leaving FSA to pay on its bond insurance policy. FSA sued the underwriter of the bonds as well as a civil engineer who prepared a feasibility study and certified the reasonableness of the budget prepared prior to the issuance of the bonds, based on alleged misrepresentations in the official statement for the insured bonds in violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder.

The district court dismissed FSA's complaint on the grounds that under U.S. Supreme Court precedent only a "purchaser or seller" of securities has standing to assert a Rule 10b-5 securities fraud claim, and that FSA, as a bond insurer, was not a "purchaser or seller" of the bonds offered under the official statement. The appellate court, in its unusual September 18 second opinion on the subject, agreed that FSA

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lacked standing, but focused on the fact that the municipal bonds were not "securities" vis-a-vis FSA.

In ruling that contractual provisions under which FSA acquired the defaulted bonds upon payment under the insurance policy did not constitute a contract to purchase "securities" for purposes of the "purchaser or seller" standing requirement, the 11th Circuit quoted standard wording in the official statement for the bonds to the effect that upon deposit of moneys with the bond trustee for the payment of the bonds, "such Bonds … will cease to be entitled to any benefit or security under the Resolution and the Owners of such Bonds … will have no rights in respect thereof except to receive payment [of such funds]." According to the court, this language established that "although FSA became the 'owner' of the bonds [upon paying the debt service that was due for payment], it did not acquire a 'security' because, by the OS's own terms, FSA acquired no right to receive interest or principal [of] the bonds after disbursement [of the bond insurance funds]." Per the court, the bonds were no longer "securities" when acquired by FSA, and therefore FSA failed the "purchaser of securities" standing requirement.

Insured municipal bond issues typically include language in a different section of the resolution or indenture that expressly states that notwithstanding any other provision in the applicable document, payment of debt service by the bond insurer does not constitute payment by the issuer, and that bonds so paid remain outstanding for all purposes and the issuer/conduit borrower remains obligated to pay the defaulted debt service on the bonds.

The 11th Circuit appellate panel may have been unaware of such language in the resolution, or such language may not have been summarized in the official statement, or for some unusual reason such language may not have been included in this particular bond issue. In any event, this factual lynchpin of the court's standing analysis would appear to be either an oversight or atypical.

For this reason, the general question of standing of bond insurers to bring securities fraud claims is unlikely to be resolved by this latest opinion. And of course, whether or not FSA or other bond insurers ultimately prevail on standing questions, there are numerous other elements to a successful securities fraud claim that a bond insurer would need to satisfy to prevail on such a claim.

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