R. DOTY

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Commentary Municipal advisors' fiduciary duty of care is more than just `professional standards'

By Robert Doty
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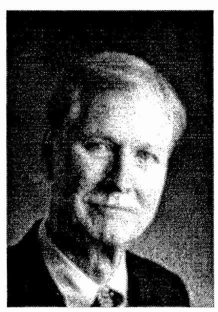
There is an unfortunate tendency by some municipal advisors to equate the advisors' fiduciary duty of due care with mere professional standards for non-fiduciary professionals. According to this overly-simplistic view, if an advisor has not been negligent as measured against non-fiduciary standards, then there cannot be a violation of the due care requirement. Further, there also is a tendency by some to believe that municipal advisors are required only to comply with MSRB Rule G-42 and other MSRB rules. Others believe that municipal advisors to obligated persons, as opposed to municipal entities, are not subject to fiduciary standards.

Robert Doty



Those perspectives are erroneous. They fail to reflect the substance and reality of the due care required when municipal advisors interact with their clients within the scope of the advisors' retentions.

Non-fiduciary professionals—who are required to adhere to industry standards for their respective professions—are not required to provide affirmative advice or statements to clients, unless retained for that purpose. This general rule is stated in the *Restatement of Torts (Second)*, a treatise by the American Law Institute that summarizes the general principles of common law United States tort law.

According to the *Restatement*, a speaker is required to speak "if, but only if, he is under a duty to the other to exercise reasonable care to disclose the matter in question." The *Restatement* enumerates, as an exception to that general rule, "a fiduciary or other similar relation of trust and confidence." Robert Fippinger elaborates in *The Securities Law of Public Finance* that "Anglo-American law tilts in favor of the person choosing to remain silent requiring an affirmative duty to speak only in limited circumstances in which the defendant has a special relationship to the person injured," citing as an exception, "a fiduciary having duties of loyalty and care to a beneficiary."

Of course, when a professional chooses to speak, even if not required to do so, the professional must do so without misrepresentation. Yet, non-fiduciary professionals have the option to remain entirely silent. Municipal advisors do not. The duty to speak implicates not only a duty to disclose conflicts of interest, a key aspect of the duty of loyalty, but also a duty to provide affirmative information and advice.

In contrast to non-fiduciary professionals, municipal advisors functioning as what the municipal market formerly called "financial advisors" commonly have been subject to common law fiduciary standards for decades. The sophistication of the client does not override the disclosure requirement. The duty to provide affirmative information is reflected, for example, in the Justice Department's and SEC's actions in the early 1990s against Mark Ferber (a financial advisor to several large, sophisticated clients), numerous SEC actions predating the Dodd-Frank Act, and legal decisions by district and appellate courts in the 2nd, 9th, 10th and 11th circuits. The 11th Circuit and the SEC applied a requirement of affirmative disclosure against a financial advisor, Michael deVegter, to a large, sophisticated municipal client. Those actions were centered on failures to disclose conflicts of interest.

The fiduciary duties of municipal advisors derive not only from the federal securities laws, including MSRB rules, but also from state law. Common law fiduciary standards reflect, among other things, the imbalance of specialized knowledge and information between advisors and their clients regarding municipal finance, the advisors' inducement of reliance upon them, the confidences that the clients repose in the advisors, and the clients' heavy reliance upon the advisors.

In addition, agency concepts, which invoke fiduciary duties under state law, come into play. As a general rule, municipal advisors, especially when functioning in financial advisory capacities, not only advise their clients, but also deal on behalf of their clients with multiple third parties, such as underwriters, bond counsel, local client counsel, underwriter counsel, investment providers, trustees/paying agents, rating agencies, and vendors and public officials providing data used in municipal advisory analyses or official statements.

As the 10th Circuit Court of Appeals stated in *SEC v. Cochran, et al.*, "When one party expressly or implicitly agrees to act as an agent or broker on behalf of another party, Oklahoma law imposes on the agent a fiduciary duty to disclose to the principal all material facts within the scope of the agency." See also *In the Matter of Daisy Systems, Inc.*, in which the Court of Appeals for the Ninth Circuit opined under California law regarding a financial advisor to a sophisticated private corporation, "Two important issues of fact that must be resolved before it can be determined whether a fiduciary relationship existed ... are the questions of agency and confidentiality," adding "Should a factfinder determine from the record that an agency relationship existed between the parties, ... then a fiduciary relation should be presumed to exist."

The Dodd-Frank Act, of course, imposed a statutory federal fiduciary duty on municipal advisors in relation to municipal entity clients, though but unlike common law, not in relation to obligated person clients. As Fippinger states, the Dodd-Frank's federal fiduciary duty "means that a single standard can be established without the necessity of relying on the fiduciary duty law of fifty different states in which various transactions occur." The Dodd-Frank Act did not, however, override the state common law fiduciary duty. As the MSRB states in connection with its Rule G-42, permission for municipal advisors to engage in certain limited principal transactions with the advisors' clients shall not "relieve the municipal advisor from any obligation that may be imposed by other applicable provisions of ... state law."

Although the same acts may constitute violations of both professional standards and the fiduciary duties of municipal advisors, in contrast with mere professional negligence standards applicable to non-fiduciary professionals, the fiduciary duties impose significantly greater market responsibilities on municipal advisors.

For example, in distinct contrast to the professional negligence standards applicable to non-fiduciary professionals, municipal advisors — being subject to the fiduciary duties of care and loyalty — have an affirmative duty to speak to their municipal entity clients. Municipal advisors do not have the option of remaining silent about matters within their scopes of retention. That is, unlike non-fiduciary professionals, municipal advisors must speak affirmatively and must provide affirmative advice and information to the municipal advisors' clients.

As Mr. Fippinger states, "Fiduciary fraud is an exception to the general rule that a person is ordinarily entitled to remain silent despite possessing information that would be material to another. If a person is in a 'fiduciary or other similar relation of trust and confidence' there is a duty to disclose the material facts, and failure to make the disclosure is fraud." The *Restatement of Agency (Third)* states the common law rule that "An agent has a duty to use reasonable effort to provide the principal with facts that the agent knows, has reason to know, or should know when (1) subject to any manifestation by the principal, the agent knows or has reason to know that the principal would wish to have the facts or the facts are material to the agent's duties to the principal[.]"

Moreover, municipal advisors must speak solely in the best interests of the clients without regard to the municipal advisors' own financial and other interests. This principle is recognized in the MSRB's 2012 interpretation of Rule G-17 in contrasting the duties of municipal advisors with those of underwriters ("unlike a municipal advisor, the underwriter does not have a fiduciary duty to the issuer under the federal securities laws and is, therefore, not required by federal law to act in the best interests of the issuer without regard to its own financial or other interests"). The principle also is recognized in the *Restatement of Agency*, which states that "the general fiduciary principle requires that the agent subordinate the agent's interests to those of the principal and place the principal's interests first," and by Tamar Frankel, a noted authority on fiduciary law, who states in Legal Duties of Fiduciaries: Definition, Duties and Remedies that that fiduciaries must act "for the sole benefit" of their beneficiaries.

The fiduciary duty to speak applies even when the municipal advisors believe that their clients may already know, or may be able to discover, the information. Tamar Frankel states that a fiduciary has "a duty to tell the entrustor how the fiduciary is providing the services and what happened to the entrustment, regardless of whether the entrustor asked for the information. The entrustor does not have to ask." The *Restatement of Agency* states that the agent's duty to provide information to the principal requires the agent to do so even if the agent believes "that the principal could, through investigation, have ascertained the truth independently." In the post-Dodd-Frank era, the SEC applied the fiduciary duty of care against a municipal advisor, Municipal Finance Services, Inc. and two officers of the firm (SEC Rel. No. 34-81475, IA-4758 (Aug. 24, 2017), who allegedly failed to provide affirmative advice to a municipal entity client regarding disclosure compliance matters within the advisor's scope of retention.

There are additional key distinctions between municipal advisors and non-fiduciary professionals specifically under the Dodd-Frank statutory pattern. One is that, under Section 20(a) of the Securities Exchange Act of 1934, control person liability is extended to advisory officials who are in positions of "control," loosely defined by courts to include less than absolute control. Once "control" is demonstrated, a control person has the burden of proof to show that he/she "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." Another is that, in SEC actions, under Section 20(e) of the Act, the Commission may prove aiding and abetting liability against parties that knowingly or recklessly assist primary violations.

In summary, municipal advisors subject to the federal Dodd-Frank fiduciary duty, or to a state common law fiduciary duty, have a duty of care to their clients that is much more comprehensive, and more demanding, than the professional standards