Ballard Spahr: SEC Charges City Mayor as a Control Person in Allen Park, Michigan, Enforcement Action.

Yesterday, the Securities and Exchange Commission (SEC) announced fraud charges against the City of Allen Park, Michigan (City), and two of its former officials—the former City Mayor and former City Administrator. It is the first time the SEC has imposed "control person" liability on a mayor, or any municipal official, under Section 20(a) of the Securities Exchange Act of 1934 (Exchange Act), which provides that a control person may be held jointly and severally liable for the securities law violations of the persons over which it exercises control.

While unprecedented, the SEC's action was not unexpected. In the May 2013 Section 21(a) Report it issued following its investigation of the City of Harrisburg, the SEC warned:

"The statements by the Harrisburg public officials were part of, and could have altered, the total mix of information available to the market. There is a substantial likelihood that a reasonable investor would consider the financial condition of the City important in making an investment decision, and there were no other disclosures made by the City as part of the total mix of information available to enable investors to consider other information. These public officials' statements were the principal source of significant, current information about the issuer of the security and thus could reasonably be expected to influence investors and the secondary market. Because statements are evaluated for antifraud purposes in light of the circumstances in which they are made, the lack of other disclosures by the municipal entity may increase the risk that municipal officials' public statements may be misleading or may omit material information."

The Allen Park matter accordingly demonstrates the resolve the SEC warned about in the City of Harrisburg matter.

The facts in Allen Park likely roughly coincide with the economic conditions many municipalities face, and with the optimistic statements many public officials make in connection with similar economic development projects. In 2008, the City initiated plans for an economic development project consisting of a $146 million movie studio with eight sound stages. The studio was to be financed and operated by a public-private partnership (PPP) consisting of a limited liability company, a producer, and a private developer. The City planned to acquire the land for the project using municipal bond proceeds and subsequently donate the land to the PPP. The bonds were to be initially repaid from revenues generated by the City from leases with media-related entities. In April 2009, the City issued a press release covering the project that included a statement from the former City Mayor characterizing the project as an "economic development blockbuster" and emphasizing the job opportunities created by the project.

In May 2009, the producer committed to pay up to $2 million to cover the City's budget deficit. The payment was contingent upon the land being donated by the City to the PPP. Shortly thereafter, the City entered into an agreement—signed by the former City Mayor—with the producer and the developer under which the developer pledged $20 million for the first phase of building the studio, according to the SEC. The SEC alleged that the PPP collapsed after the City was informed in July

2009 by its bond counsel that it was prohibited from using bond proceeds to purchase land that would be donated to the PPP. By August 2009, plans for the project had deteriorated into leasing a piece of the property for the operation of a movie production vocational school.

Despite the knowledge of the former City Mayor, the SEC alleged he made false statements to the public and the City Council about the timing and scope of the project in a press release and public meeting. The SEC also alleges that neither the former City Mayor nor former City Administrator disclosed to the City Council any of the negative developments affecting the project prior to the issuance of the municipal bonds. Although the former City Mayor was alleged to have promoted the underlying project, the SEC's action does not rest on that fact alone.

The City issued $31 million in municipal bonds in November 2009 and June 2010. According to the SEC, the City Administrator provided information used in drafting the offering documents, reviewed the offering documents, and providing certification that the information contained therein was true, correct, and complete. According to the SEC, the offering documents failed to disclose the negative developments concerning the project. The SEC further alleged the offering documents contained material misstatements about the projected lease revenue available to pay bondholders as well as the City's financial health.

The SEC charged the City and the City Administrator with violating Section 17(a)(2) of the Securities Act of 1933 (Securities Act) and Section 10 (b) of the Securities Exchange Act and Rule 10b-5(b). The City consented to a cease-and-desist order without admitting or denying the findings of the SEC. Without admitting or denying the findings of the SEC, the City Administrator consented to a final judgment barring him from participating in municipal bond offerings and enjoining future securities law violations.

The SEC charged the former City Mayor under Section 20(a) of the Exchange Act based on his position as a controlling person of the City and the City Administrator at the time the alleged fraud was committed. The former City Mayor consented to a final judgment barring him from participating in municipal bond offerings and enjoining future securities law violations without admitting or denying the SEC's findings. The former City Mayor also agreed to pay a $10,000 financial penalty.

In the SEC press release announcing its charges, Chief of the SEC's Municipal Securities and Public Pensions Unit LeeAnn Gaunt stated that "[w]hen a municipal official like [the City Mayor] controls the activities of others who engage in fraud, we won't hesitate to use every legal avenue available to us in order to hold those officials accountable."

The SEC's action against the former City officials is consistent with its increased focus on individual liability. This increased focus has been brought into sharper relief through the parameters of the SEC's Municipalities Continuing Disclosure Cooperation (MCDC) Initiative, under which the SEC has attempted to incentivize issuers and obligated persons to come forward and disclose misstatements in primary offering documents relating to past compliance with continuing disclosure obligations. The MCDC Initiative, however, offers no protection to individuals the issuers or obligated persons employ. Accordingly, and consistent with the views we previously expressed, issuers and obligated persons should carefully consider the consequences of participating in the Initiative.

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