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Mintz Levin: SEC Introduces "Control Person" Liability as Enforcement Action Weapon in Claim Against Municipal Officer for Misleading Bond Offering Document.

The U.S. Securities and Exchange Commission recently settled the first securities fraud charges brought against a municipal official alleging "control person" status under the federal securities laws. The SEC's settlement with the former mayor of the city of Allen Park, Michigan bars him from participating in future securities offerings and imposes a \$10,000 penalty. A city administrator also was charged and barred from participation in future securities offerings

The SEC's enforcement actions, brought against the city and the two city officials, alleged that the offering documents for a "double-barreled" general obligation bond issue contained false and misleading statements. In particular, the SEC alleged that the offering documents failed to disclose adverse developments relating to a proposed public-private transaction for a film studio project to be located on land purchased with the bond proceeds; the project was not consummated, leading to financial difficulties that caused the state of Michigan to appoint an emergency manager for the city. The bonds issued for the project were rated A by S&P and subsequently downgraded to BB+, and recent audited financial statements for the city have carried a going concern qualification.

The enforcement action against the city was brought under Section 17(a)(2) of the Securities Act of 1933, which permits administrative action by the SEC for negligent conduct, and under SEC Rule 10b-5, which permits administrative action by the SEC as well as a private right of action by affected investors, but requires proof of "scienter", or an intent to deceive (which has been interpreted to include highly unreasonable conduct or recklessness.)

More notably, the SEC charged the mayor as a "control person" under Section 20(a) of the Securities Exchange Act, under which any person who directly or indirectly "controls" another person found liable for a violation of the Securities Exchange Act or any regulation thereunder is jointly and severally liable, to the same extent as the controlled person, to any person to whom the controlled person is liable. Liability as a "control person" can be avoided if the "control person" establishes that he or she acted in good faith and did not directly or indirectly induce the act or acts constituting the violation.

Liability under Section 20(a) generally requires two elements: a primary violation of the federal securities laws by the "controlled person", and proof that the person charged with the Section 20(a) "controlled" the primary violator. It is unclear whether there are any circumstances under which a municipal official sitting on a multi-person board or council could be held to "control" an issuer, or issuer personnel, found to be a primary violator responsible for fraudulent statements in an offering document for municipal securities. But in the Allen Park enforcement action the SEC appears to have alleged that the mayor controlled the city, the alleged primary violator.

If a primary violation and "control" of the person or entity that made the misleading statement is established, the burden shifts to the "control person" to establish good faith, which, unsurprisingly, means the absence of bad faith, which is akin to the absence of scienter. In theory, even if an

accused official does not establish good faith, he or she can avoid liability upon proof that he or she did not “induce” the primary violation. The courts have not conclusively adjudicated whether to “induce” requires active encouragement, or whether in some circumstances the failure to exercise efforts to prevent a violation can be deemed to induce the violation.

The Allen Park enforcement action was settled by the issuer and the officials without admitting or denying liability, and sets no precedent on what type of conduct by an issuer official constitutes “control” over a primary violator of the securities laws or induces the violation. But it suggests that in the aftermath of U.S. Supreme Court decisions that have eliminated aiding and abetting liability in private actions under Section 10(b) of the Securities Exchange Act and narrowed the circle of potential primary violators that the SEC can allege “make”, within the meaning of Section 10(b), a fraudulent statement in a securities offering document, the SEC intends, when feasible, to use a “control person” theory to go after actors it deems culpable for securities fraud in municipal offerings but cannot reach as primary violators.

Initial reaction to the SEC’s introduction of “control person” charges to municipal securities enforcement actions has included concern that public officials involved with municipal entities that issue bonds or other securities may now face charges and potential vicarious liability for disclosure malfeasance by other issuer officers or employees. However, the SEC will face an uphill battle proving allegations of “control”, bad faith and “inducement” of a primary violation by an issuer board member or official who may have approved the distribution of an official statement but was not actively involved in its preparation, did not sign the official statement, and did not urge another official to exclude or include particular disclosure. The extent to which the SEC will include “control person” charges in future enforcement actions alleging primary securities law violations by an issuer or another issuer official remains to be seen, but such charges are most likely to be brought where there is evidence of active complicity in deceptive disclosure.

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