

INSIGHTS

SEC Secures Federal Judge Order Against Mayor Based on Control Person Liability

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On January 28, 2015, the United States District Court for the Eastern District of Michigan entered a final judgment against Gary Burtka, the former mayor of Allen Park, Michigan, upholding the Security and Exchange Commission (SEC)'s first effort to charge a municipal official with "control person" liability.¹

The SEC's charges against Burtka related to materially false and misleading statements made in offering documents for two municipal bond issuances in 2009 and 2010.² Burtka was not alleged to have participated in drafting the misleading bond offering documents, but rather was charged as a control person.

Although the District Court initially balked at the SEC's proposed settlement agreement for its apparent failure to implicate underwriters, financial advisors, and law firms involved with the transaction, the District Court implemented the original settlement agreement following supplemental briefing by the SEC that demonstrated the limited role of the public finance professionals in the transactions at issue.³ This outcome, embracing the SEC's argument that "because Defendant Burtka controlled the City and the City Administrator during the period that each one violated the federal securities laws, he is liable for their violations to the same extent each one of them is liable,"⁴ is one of which every official of a state or local government issuing debt should be aware.

Background

On November 6, 2014, the SEC announced that it had filed fraud charges against the City of Allen Park, former Mayor Burtka, and former City Administrator Eric Waidelich for their actions in connection with two bond offerings.⁵

The \$31 million in general obligation municipal bond offerings were intended to fund a \$146 million movie studio project in Allen Park.⁶ Although the project initially had additional financial backing from a public-private partnership between the City, a private developer and a Hollywood movie producer, the partnership disintegrated before the first bonds were issued in November 2009. These material developments were not disclosed to investors in the municipal bond offering documents.

Charges were subsequently brought against the City and Waidelich under Section 17(a)(2) of the Securities Act of 1933, and Section 10(b) and Rule 10(b)-5 of the Exchange Act of 1934, which prohibit the use of materially false or misleading information in the issuance of

securities.

Significantly, Burtka was charged under Section 20(a) of the Exchange Act, which provides for joint and several control person liability against persons with authority to oversee and direct individuals involved with securities offerings.⁷ As such, even though Burtka was not alleged to have participated in drafting the disclosure documents at issue, or even to have had any knowledge regarding the contents of the disclosure documents, the SEC found him liable “with and to the same extent as the City and the City Administrator.”⁸

Procedural History and Final Judgment

All parties agreed to settle with the SEC. On November 6, 2014 the City entered into a voluntary cease-and-desist order, and agreed to implement remedial measures including adoption of a compliance and training program for city officials involved with future bond offerings.⁹ On the same date, Burtka agreed to settle and pay a \$10,000 penalty to the SEC. Waidelich, who settled charges that he reviewed and approved the offering documents at issue, demonstrated an inability to pay a financial penalty and therefore was not fined.¹⁰ Both Burtka and Waidelich were barred from participating in any future municipal bond offerings.

After approving the SEC settlement on November 6, 2014,¹¹ the District Court subsequently reversed its order on November 7, 2014.¹² Stating that the judgment was “improvidently entered,” District Judge Avern Cohn took issue with the Commission’s failure to mention “the role of financial advisors, underwriters and law firms” – *i.e.*, sophisticated parties who presumably participated in the securities offering at issue – in its complaints against Burtka and Waidelich for their actions in connection with the bond offerings.¹³

Following supplemental briefing by the SEC and the declaration of Mark Zehner, Deputy Chief of the Municipal Securities and Public Pensions Unit of the SEC’s Division of Enforcement, which detailed the SEC’s investigative process, the District Court was satisfied that the “underwriters had no responsibility for the misstatements in the Official Statements because the bonds were sold by competitive bid,” meaning that the underwriters did not participate in the drafting of the offering documents.¹⁴ Further, the District Court accepted the SEC’s position that the financial advisors “relied on what Waidelich or City employees told it” and “had no obligation in formulating an official statement,” and therefore could not be held liable, and that bond counsel was “retained for a limited purpose, that is the tax treatment of the bonds.”¹⁵ In effect, the District Court approved the terms contained in the SEC’s initial settlement agreement.

Judge Cohn expressed concern that “today the State of Michigan lacks a mechanism to review the legitimacy of municipal borrowings before debt instruments are issued,” as the Michigan Department of the Treasury Local Audit and Finance Division reviews documents relating to bonds only after the bonds are issued, and that it is “therefore fair to say that the State steps in only and after the barn door is closed and the horse escapes.”¹⁶

Implications

These developments indicate that the SEC is able to overcome an apparent trend of judicial reticence in approving SEC settlements. For example, in November 2011 District Judge Jed Rakoff refused to approve a SEC settlement agreement with Citigroup regarding Citigroup’s sale of mortgage-backed securities prior to the 2008 financial crisis.¹⁷ Although the Second Circuit

Court of Appeals overturned Judge Rakoff's decision in August 2014, the Allen Park and Citigroup cases embody close federal court scrutiny over SEC settlements.

Notwithstanding the District Court's initial hesitance to approve the SEC's settlement with Burtka, the Allen Park case is a win for the SEC that will likely encourage the Commission to continue to charge more individuals, including public officials, and particularly control persons, with violations of the securities laws.¹⁸

Finally, the decision is a reminder to municipalities to ensure that they and their officials are protected by obtaining meaningful review by counsel and other professionals of disclosure documents prior to issuing bonds.

¹ Although this is the SEC's first effort to assert control person liability under Section 20(a) of the Securities and Exchange Act of 1933, private litigants asserted Section 20(a) claims against municipal entities in the 1980s. See *In re CitiSource, Inc. Sec. Litig.*, 694 F. Supp. 1069 (S.D.N.Y. 1988).

² Press Release 2014-249, SEC Charges Allen Park, Mich. And Two Former City Leaders in Fraudulent Muni Bond Offering for Movie Studio Project, 1 (Nov. 6, 2014), available at <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543373355#.VFvGRLEo6DZ>.

³ Comments of the Court on Approving Consent Judgments, *SEC v. Gary J. Burtka and Eric C. Waidelich*, No. 14-14278 and 14-14279 (Jan. 28, 2015).

⁴ Complaint at 2, *SEC v. Gary J. Burtka*, 2:14-CV-14278 (Nov. 6, 2014), available at <http://www.sec.gov/litigation/complaints/2014/comp-pr2014-249-burtka.pdf>

⁵ Press Release 2014-249.

⁶ Complaint at 5, *SEC v. Eric C. Waidelich*, 2:14-CV-14279 (Nov. 6, 2014), available at <http://www.sec.gov/litigation/complaints/2014/comp-pr2014-249-waidelich.pdf>.

⁷ Complaint at 14, *SEC v. Gary J. Burtka*, 2:14-CV-14278 (Nov. 6, 2014), available at <http://www.sec.gov/litigation/complaints/2014/comp-pr2014-249-burtka.pdf>.

⁸ *Id.* at 14.

⁹ Order Instituting Cease-And-Desist Proceedings at 1, 6, *In re City of Allen Park*, File No. 3-16259 (Nov. 6, 2014), available at <http://www.sec.gov/litigation/admin/2014/33-9677.pdf>.

¹⁰ Final Judgment as to Defendant Eric C. Waidelich, *Securities and Exchange Comm'n v. Waidelich*, No. 14-14279 (E.D. Mich. Jan. 28, 2015).

¹¹ Final Judgment As To Defendant Gary J. Burtka, *Securities and Exchange Comm'n v. Gary J. Burtka*, No. 14-14278 (Nov. 6, 2014).

¹² Order Vacating Final Judgment, *Securities and Exchange Comm’n v. Gary J. Burtka*, No. 14-14278 (E.D. Mich. Nov. 7, 2014).

¹³ *Id.*

¹⁴ Comments of the Court on Approving Consent Judgments, *SEC v. Gary J. Burtka and Eric C. Waidelich*, No. 14-14278 and 14-14279, 5 (Jan. 28, 2015).

¹⁵ *Id.*

¹⁶ *Id.* at 7.

¹⁷ Rob Tricchinelli, Rakoff Approves SEC-Citigroup Settlement, Saying Second Circuit Left Him With “Sour Grapes,” Bloomberg BNA (August 8, 2014), available at <http://www.bna.com/rakoff-approves-seccitigroup-n17179893500/>.

¹⁸ SEC Chair Mary Jo White also recently noted that the SEC pursues individual charges in the majority of its private enforcement cases; since 2000, 93 percent of the SEC’s proceedings against listed firms have included individual charges. See Mary Jo White, Three Key Pressure Points in the Current Enforcement Environment, Speech to NYC Bar Association’s Third Annual White Collar Crime Institute (May 19, 2014), available at <http://www.sec.gov/News/Speech/Detail/Speech/1370541858285#.VHNvObEo6Um>.