

Texas AG's Win In SEC Battle Won't Shut Down Fraud Charges

By **Jess Krochtengel**

Law360, Dallas (October 12, 2016, 9:33 PM EDT) -- The dismissal of civil securities fraud claims against Texas Attorney General Ken Paxton should put a valuable arrow in his quiver as he aims to take out similar criminal charges, but he's still far from closing the door on allegations he misled potential investors, white collar experts say.

Paxton notched a significant win last week when U.S. District Judge Amos Mazzant conditionally dismissed a U.S. Securities and Exchange Commission lawsuit accusing him of misleading investors in the tech hardware company Servergy Inc. by not telling them he would earn a commission, with the judge finding Paxton had no duty to disclose. But on Wednesday, the Court of Criminal Appeals of Texas, the state's highest criminal court, knocked down his petition to throw out felony fraud charges also stemming from his work with Servergy.

While Judge Mazzant's decision doesn't carry precedential weight with the state courts overseeing the criminal case, white collar lawyers say it is a credible finding with regard to some of the same issues, so it's very helpful for the defense. Yet they also say the criminal case comes with different procedural hurdles — for example, a Texas statute that isn't identical to federal securities laws and has a much smaller body of case law developed around it — that make it harder for the defense team to bring a quick end to the matter.

Paxton's team has signaled its plans to file a motion for rehearing with the Court of Criminal Appeals, saying if the SEC can't make its civil fraud claims stick, prosecutors shouldn't be able to move forward under the higher standard of proof required in criminal law. They're likely hoping Judge Mazzant's decision could sway the court to give him a second chance, said Matthew G. Nielsen of Andrews Kurth Kenyon LLP, who chairs the firm's white collar and regulatory enforcement group.

"I don't know how it's going to play out, but certainly his lawyers are going to be waving that opinion around," Nielsen said. "I'd be surprised if it doesn't get some attention."

Paxton is charged with — and has pled not guilty to — failing to disclose to investors that he would earn a commission worth \$100,000 for selling them Servergy stock, as part of a fundraising campaign that took place before he was elected AG but while he was serving as a state representative. Prosecutors say he intentionally failed to disclose the compensation and didn't tell investors he was not investing his own money in Servergy to induce them into buying the stock.

The SEC alleged in a civil suit brought in April that two investors Paxton had solicited, including a fellow

state representative, would not have invested in Servergy had they known Paxton was being paid to promote the company. Judge Mazzant held that under the facts pled by the SEC, Paxton did not have a legal obligation to disclose his financial arrangement to investors, and it concluded that he did not have a fiduciary relationship with an investors' club to which he'd recommended the Servergy stock.

Based on Judge Mazzant's conclusion, Paxton's defense counsel is likely to argue that the criminal charges against him should fail because he had no obligation to tell investors about his compensation agreement, Nielsen said.

"What they're undoubtedly going to argue is the federal and state laws aren't that different and the standard is largely the same on the basic prohibition against material omissions," Nielsen said. "They're going to argue Judge Mazzant found no duty to disclose under federal law and there's no difference in the state securities laws."

Still, significant challenges remain for Paxton in bringing an end to the criminal case. One major hurdle is that prosecutors need only lay out the elements of a crime in what can be a "bare bones" indictment, said John Richter of King & Spalding LLP. Civil cases require claims be pled with particularity, but specifics aren't required in criminal cases, which makes them harder to defeat before trial — even though a higher standard of proof is needed to actually win a criminal case than in civil disputes, he said.

"Typically, most state criminal cases are not beat by attacking the pleadings, while in civil cases you have a natural vehicle to do so," Richter said.

Also making it more difficult to dismiss a criminal case early in the process is that the Texas State Securities Act is "not nearly as well-litigated, considered, analyzed nor discussed by the courts as the federal securities laws," Arnold Spencer of Spencer & Associates said.

Spencer said he expects the criminal case to end up in a trial, where the key issue would be the materiality of the alleged omissions.

"You can argue it can't possibly be material if you don't have the duty to disclose," Spencer said. "That's a fact issue for the jury in a criminal case but a legal issue in federal securities case."

He said if the case went to trial, Paxton would likely spend a substantial amount of time putting on witnesses who would testify that the compensation agreement and the fact that he didn't invest his own money in the company was not material to their decision to buy the stock.

Another wrinkle in getting the criminal case thrown out is that Judge Mazzant's dismissal order by itself legally shouldn't affect the criminal case, Richter said. It's not precedential on the state court, but it's also not a factual finding — it's simply the court saying that based on the allegations made in the complaint, the SEC didn't state a valid claim, he said. It's not a given that the criminal case would be impacted by the judge's conclusions, he said.

Under the federal court's ruling, the SEC has 14 days to amend its complaint against Paxton. Richter said he would expect the agency to try again, laying out more facts and possibly newly stated theories of liability. Paxton would almost certainly file a second motion to dismiss at that point, and the judge's second ruling could be a significant litmus test for the criminal case, he said.

"If the SEC can't shore up its pleading, that may suggest there are vulnerabilities in the prosecution's

case,” he said.

And if Paxton’s team can bring home a second dismissal, that could sway the state judiciary to pay heed to Judge Mazzant’s ruling despite its procedural limitations, he said.

“I think at the end of the day, if they're able to get this to stick, it should make the Texas state court judge more amenable to listening because he knows a fellow judge has raised questions,” Richter said.

Spencer said while the AG’s legal team is surely pleased with the dismissal of the SEC claims and can now focus their resources on the criminal case, the ruling is no surefire sign Paxton can ditch the criminal charges. This is a different jurisdiction, a different statute and a different standard of proof, he said.

“This is far from over for Paxton,” he said. “He is not out of the woods.”

The state is represented by special prosecutors Brian Wice, Kent Schaffer and Nicole DeBorde.

Paxton is represented by Philip Hilder, Tate Williams and Paul Creech of Hilder & Associates PC, Dan Cogdell of Cogdell Law Firm, Heather Barbieri of Barbieri Law Firm PC, Bill Mateja of Polsinelli PC, Mitch Little of Scheef & Stone LLP and Terri Moore.

The case is Ex Parte Warren Kenneth Paxton Jr., case numbers PD-0891-16, PD-1892-16 and PD-0893-16, in the Court of Criminal Appeals of the State of Texas.

--Editing by Mark Lebetkin and Philip Shea.