

Texas AG's Win Over SEC Raises Doubts About Criminal Case

By **Jess Krochtengel**

Law360, Dallas (March 6, 2017, 9:02 PM EST) -- The toss of a civil securities fraud suit against Texas Attorney General Ken Paxton could signal trouble for prosecutors pursuing related criminal charges, who face a higher burden to prove that Paxton should have disclosed potential commissions to investors and may lack the evidence to clear that hurdle, experts say.

Dismissing the U.S. Securities and Exchange Commission's fraud claims against Paxton with prejudice, U.S. District Judge Amos Mazzant III found Thursday that Paxton didn't owe a fiduciary duty to a group of investors to whom he had promoted stock, and thus wasn't required to disclose he would be paid a commission. It was the second time Judge Mazzant had dismissed the SEC's case against Paxton, after giving the agency a chance to amend its complaint with additional supporting facts.

While Judge Mazzant's findings have no direct effect on the pending felony securities fraud charges Paxton faces in Texas state court, white collar lawyers say the civil outcome casts a shadow on the ability of prosecutors to prove Paxton's guilt. The SEC likely would have pulled out all the stops in its attempt to revive the fraud case against Paxton, so it's hard to imagine the prosecution would have substantially different evidence about Paxton's alleged failure to disclose his alleged commission agreement, they say. And winning conviction in a criminal case requires a higher burden of proof than in a civil matter, adding another layer of difficulty.

"The SEC had two bites at the apple," John Richter of King & Spalding LLP said. "One would think the SEC would have included the most relevant facts to satisfy the federal securities fraud claims. The Texas securities laws have sufficient similarity that it should raise real questions about those charges."

Both the criminal case and the civil case relate to allegations Paxton promoted the stock of Texas-based technology company Servergy Inc. without disclosing to investors he would earn commissions for recruiting them and that he had not personally invested in the company. Paxton belonged to an informal investment group of four men to whom the SEC argued he owed a fiduciary duty, but Judge Mazzant rejected that theory, saying subjective trust is "too thin a reed" on which to base a federal securities lawsuit.

In the criminal case, Paxton faces two first-degree felony charges for omission of material facts. He also faces a third-degree felony charge for failing to register as an investment adviser representative.

Richter said while he hasn't read every piece of Texas precedent on the topic, he believes Texas state securities laws are "pretty well aligned" with federal laws regarding a duty to disclose. Even if

prosecutors have a good shot at establishing the payment of a \$100,000 commission is a material fact, the question is whether he owed those potential investors a duty to disclose that fact, Richter said.

“That duty to speak is a separate element that has to be considered regardless of materiality of the statement or omission in question,” Richter said. “It still comes down to whether as a matter of law the defendant had a duty to speak under the circumstances.”

Matthew Nielsen of Andrews Kurth Kenyon LLP said traditionally in omissions cases like the one Paxton faces, there’s a requirement to show the accused fraudster had an obligation to disclose the material facts at issue. While Judge Mazzant found the duty didn’t apply in the circumstances of the Servery investments, prosecutors will obviously argue to the contrary, he said.

“The civil and criminal cases from a factual standpoint align pretty closely,” Nielsen said. “On its face, it would seem [the prosecution] would have to come up with more than the SEC pled.”

Richard Roper of Thompson & Knight LLP said he “can’t imagine” the SEC didn’t have access to the same evidence the special prosecutors have and said he thinks the agency would have pled whatever facts it could to maintain the civil case against Paxton.

“You would think the SEC probably took the best shot, and had access, and used essentially everything the DA had,” Roper said. “But we’ll see.”

Roper said as a matter of equity, Paxton could argue to the prosecutor to not bring the two fraud charges alleging fraud by omission to trial, citing Judge Mazzant’s opinion. But the state courts aren’t bound by the ruling, and Texas fraud statutes are very broad, he said.

The prosecution in the criminal case has shown no signs of pulling back on the reins after Judge Mazzant’s ruling.

“One case has no bearing on the other,” prosecutor Kent Schaffer told Law360 Monday. “One is governed by federal civil securities law, and the other is governed by state criminal law. In addition, one will be decided by a jury.”

Paxton has called the years of investigation and prosecution a “political witch hunt” without merit, and his defense team has vowed to fight for full exoneration in the criminal case.

Procedurally, Paxton could potentially attack the securities fraud charges in a renewed motion to quash the indictment, focusing on Judge Mazzant’s duty-to-disclose finding, Roper said. If the defense doesn’t go that route, the case will proceed to trial, and the defense could bring a motion for directed verdict and motion for judgment of acquittal after the government presents its case, arguing there was no duty to disclose, Roper said.

The duty-to-disclose issue isn’t likely to be litigated at the district court level before the case reaches a jury trial, Richter said. And once you’re dealing with a group of lay jurors, the intricacies of legal arguments change a bit, he said.

“But there’s still this question of whether the defendant had a cognizable duty to disclose this, given his role not as a full-time broker-investment adviser, but rather in these circumstances as someone who was introducing the investors to these Synergy folks,” Richter said.

The criminal matters are currently set for trial May 1 before Tarrant County District Judge George Gallagher, who was appointed to preside over the case that was filed in Collin County. The parties are awaiting a decision on the prosecution's argument that the trial needs to be relocated away from Collin County because of potential bias in the jury pool.

"Look, it was a big victory for Paxton, there's no question about it," Roper said. "Whether that'll be persuasive authority to Judge Gallagher, we'll just have to see."

The SEC is represented by staff attorneys Matthew J. Gulde, Timothy L. Evans, Jessica B. Magee and Samantha S. Martin.

Paxton is represented in the civil case by Matthew T. Martens, Jaclyn N. Moyer, Alyssa DaCunha and Kevin Gallagher of WilmerHale, Bill Mateja of Polsinelli PC, and Mitch Little of Scheef & Stone LLP.

Paxton is represented in the criminal case 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 civil case is Securities and Exchange Commission v. Mapp et al., case number 4:16-cv-00246, in the U.S. District Court for the Eastern District of Texas. The criminal case is Texas v. Warren Kenneth Paxton Jr., case numbers 416-81913-2015, 416-82148-2015 and 416-82149-2015, in the District Court of Collin County, Texas.

--Editing by Philip Shea and Mark Lebetkin.