UNITED STATES DISTRICT COURT
MIDDLE DISTRICT OF FLORIDA
TAMPA DIVISION

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

v. CASE NO: 8:09-cv-87-T-26TBM

ARTHUR NADEL; SCOOP CAPITAL, LLC; and SCOOP MANAGEMENT, INC.,

Defendants,

SCOOP REAL ESTATE, L.P.,
VALHALLA INVESTMENT PARTNERS, L.P.,
VALHALLA MANAGEMENT, INC.,
VICTORY IRA FUND, LTD.,
VICTORY FUND, LTD.,
VIKING IRA FUND, LLC,
VIKING FUND, LLC; and
VIKING MANAGEMENT, LLC,

Relief Defendants.
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QUEST ENERGY MANAGEMENT GROUP, INC.'S MEMORANDUM IN OPPOSITION TO RECEIVER'S MOTION TO EXPAND THE SCOPE OF THE RECEIVERSHIP TO INCLUDE QUEST ENERGY MANAGEMENT GROUP, INC.

Quest Energy Management Group, Inc. ("Quest") responds to the Receiver's motion to expand the scope of the Receivership to include Quest, Doc. 993. As is explained in the following Memorandum, the Receiver is not entitled to the relief requested because: (1) the Court lacks personal jurisdiction over Quest, because the Receiver has not served Quest with process; (2) Quest is not an alter ego of the entities that are part of the Receivership; and (3)

inclusion in the Receivership is not an available remedy under the Promissory Note the Receiver alleges Quest breached.

MEMORANDUM

I. Background

The facts relevant to this motion are set forth in the Affidavit of Paul Downey, the Chairman and Chief Executive Officer of Quest (the "Downey Affidavit"), which is attached to this Memorandum as Exhibit A. Quest is an oil and gas production company in Texas that was established in 2005. Ex. A ¶¶ 2-5. Paul Downey is a Director of Quest, and his son Jeff Downey is the President, Chief Operations Officer, and a Director of Quest. *Id.* ¶ 7.

The Receiver's potential claim against Quest involves investments in Quest by Chris and Neil Moody and their affiliated companies, Viking Oil & Gas, LLC ("Viking Oil"), and Valhalla Investment Partners, LP ("Valhalla"). In their dealings with these investments, Quest regarded the Moodys, Valhalla, and Viking Oil as a single investor or capital source. *Id.* ¶ 30.

In January 2006 and April 2007, the Moodys and Viking Oil made two investments in Quest totaling $4 million in exchange for a 50% working interest in a group of production properties known as Quest Silverado # 1. Ex. A ¶¶ 19, 20; Doc. 994 Ex. C, D. The Moodys' and Viking Oil's interest in these properties obligated them to bear a pro rata share of the development costs of the properties. Ex. A ¶ 31. After the initial $4 million investment was exhausted, the Moodys and Viking Oil incurred an additional amount owed of over $4.8 million, which is reflected on the Joint Interest Billing Statement attached as Exhibit 3 to the Downey Affidavit. *Id.* ¶¶ 32, 33. The amount Viking Oil owes has not been paid by the Moodys, Viking

Oil, or the Receiver; instead, it has been borne by Quest and its other investors. *Id.* ¶¶ 33, 34, 38.

In November 2007 and July 2008, the Moodys and Valhalla loaned Quest a total of $1.1 million pursuant to a Promissory Note. Ex. A ¶ 23. While the Promissory Note had a due date of January 2009, the Moodys agreed it would be extended indefinitely, until the fund-raising that was contemplated at the time the Promissory Note was entered into had been completed. *Id.* ¶ 24. Quest has made a total of $545,936.69 in payments on the Promissory Note, making regular payments except in certain months in which it has been unable to do so due to cash flow problems. *Id.* ¶¶ 43, 44.

The Moodys, Viking Oil, and Valhalla are among a number of other investors whose total investments far exceed the investments of the Moodys and their affiliated companies. Quest has raised a total of over $21.3 million in funds from approximately 135 investors, with over $15 million of that sum having come from investors other than the Moodys, Viking Oil, and Valhalla. Ex. A ¶ 29.

Forcing Quest into the Receivership will likely leave Quest valueless. Quest's most valuable assets, its oil and gas leases, are held by production. Ex. A ¶ 47. If the company ceases production, the leases will automatically be terminated. *Id.* Additionally, virtually all of Quest's assets are pledged or encumbered, such that there would be little or no assets of any value to liquidate. *Id.* As a result, while it is hoped that leaving the company free to do business will result in Quest being able to retire all of its debts, including the Promissory Note, and ensure all its investors receive a return of their capital, *id.* ¶¶ 45, 46, placing Quest in the Receivership will

instead create a large class of investors unaffiliated with the Moodys or the Nadel scheme who will be harmed. *Id.* ¶ 48.

II. Because the Receiver has failed to serve Quest with process, the Court lacks personal jurisdiction over Quest.

The Receiver's motion should be denied because the Court lacks personal jurisdiction over Quest. It has not been served with process or otherwise brought within the Court's jurisdiction. Quest is not a party to this action and has not been served with process. "[S]ervice of process is the means by which a court asserts its jurisdiction over the person." *S.E.C. v. Ross*, 504 F.3d 1130, 1138 (9th Cir. 2007). Accordingly, "[a] federal court is without personal jurisdiction over a defendant unless the defendant has been served in accordance with Fed. R. Civ. P. 4." *Id.* (quoting *Benny v. Pipes*, 799 F.2d 489, 492 (9th Cir. 1986)). "Without a proper basis for jurisdiction, or in the absence of proper service of process, the district court has no power to render any judgment against the defendant's person or property unless the defendant has consented to jurisdiction or waived the lack of process." *Id.* at 1138-39. Failure to comply with Rule 4's requirements is not a "minor defect" and cannot be cured with actual notice. *Id.* at 1140.

Although Quest is not a party to this action and has not waived process, the Receiver did not serve Quest with process in accordance with Rule 4, but merely mailed the motion to have Quest included in the Receivership to Quest's counsel by United States Mail. Because Quest has not waived service of process and does not consent to the Court's exercise of jurisdiction over it in the absence of process, the Court has not acquired personal jurisdiction over Quest.

Accordingly, any judgment the Court entered on the Receiver's motion would be void. *See Ross*, 504 F.3d at 1139.

III. The Receivership may not be extended to include Quest because Quest is not an alter ego of the Receivership entities.

The Receiver argues that the Court should include Quest in the Receivership on the theory that Quest received proceeds of the Nadel scheme. Doc. 994 at 11-14. The fact proceeds of the scheme were invested in a lawful, pre-existing, separate business organization does not entitle the Receiver to have the organization included in the Receivership. Instead, a court's authority to extend a receivership to include additional entities is limited to those that are alter egos of receivership entities.

The Receiver cites *S.E.C. v. Elmas Trading Corp.*, 620 F. Supp. 231, 233-234 (D. Nev. 1985), *aff'd* 805 F.2d 1039 (9th Cir. 1986), and *S.E.C. v. Elliott*, 953 F.2d 1560, 1565 n.1 (11th Cir. 1992), for the proposition that a court may expand a receivership to include entities related to the receivership entities under certain circumstances. Doc. 993 at 11-12. The cases the Receiver cites make clear that entities may be brought into a receivership if they are so closely entwined with a receivership entity as to be the alter ego of that entity. *Elmas Trading*, 620 F. Supp. at 233-41; *see also Elliott*, 953 F.2d at 1565 n.1. The alter ego doctrine allows a court to pierce the corporate veil against a party where that party participated in a "course of conduct constituting the abuse of corporate privilege." *Elmas Trading*, 620 F. Supp. at 233. As the *Elmas Trading* court explained, the Court should consider the following factors in deciding whether to pierce the corporate veil:

> failure to observe corporate formalities; nonpayment of dividends; the insolvency of the debtor corporation at the time; siphoning of funds of the corporation by the dominant stockholder; nonfunctioning of other officers or director; absence of corporate records; use of the same office or business location by the corporation and its individual stockholders; and the fact that the corporation is merely a facade for the operations of the dominant stockholder or stockholders.

Id. at 233-34. Additional factors the Court may consider include the following:

> the comingling of funds and other assets; the unauthorized diversion of funds or assets to other than corporate purposes; the treatment by an individual of corporate assets as his own; the failure to maintain minutes or adequate corporate records and the confusion of the records of the separate entities; the identity of equitable ownership in the two entities; the identity of the officers and directors of the two entities, or of the supervision and management; the absence of corporate assets; the use of a corporation as a mere shell, instrumentality or conduit for a single venture or the business of an individual or another corporation; the concealment and misrepresentation of the identity of the responsible ownership, management, and financial interest or concealment of personal business activities; the disregard of legal formalities and the failure to maintain arm's length relationships among related entities; the use of the corporate entity to procure labor, services, or merchandise for another person or entity; the diversion of assets from a corporation by or to a stockholder or other person or entity to the detriment of creditors, or the manipulation of assets and liabilities between entities so as to concentrate the assets in one and the liabilities in another; the contracting with another with intent to avoid performance by the use of a corporation as a subterfuge of illegal transactions; and the formation and use of a corporation to transfer to it the existing liability of another person or entity.

Id. at 234.

The district court in *Elmas Trading* examined the facts related to the above factors in deciding the motion of the receiver in that case to include additional entities in the receivership. While the court granted the receiver's motion as to several companies that were shown to be alter egos of receivership entities, the court declined to bring into the receivership those companies as to which the necessary showing had not been made. 620 F. Supp. at 235-41. For

instance, the court denied the motion of the *Elmas Trading* receiver to include in the receivership a company that the receiver failed to "provide any information concerning the ownership, control or organization" of. *Id.* at 236. With regard to another entity, the receiver showed that funds had been transferred to the company, but did not furnish information regarding the legal status of the company or the business purpose of the transfer of funds. *Id.* at 238-39. The court held that the mere transfer of funds was "insufficient" to show the company was an alter ego of the receivership entities that should be included in the receivership. *Id.* at 239.

Here, the Receiver has not even attempted to make any showing regarding the factors the Court must consider in determining whether Quest may be treated as an alter ego of the Receivership entities. No such showing could be made here. Quest is a legitimate company with a separate identity independent of any of the Receivership entities. Ex. A ¶¶ 2-5. As is explained in detail in the Downey Affidavit, Quest has at all times observed the appropriate corporate formalities and maintained the required corporate records. *Id.* ¶¶ 10-16. While the Moodys and two of the Receivership entities invested in Quest, at no time have either of the Moodys or any Receivership served as officers or directors of Quest. *Id.* ¶ 9.

The Receiver has not and could not make any showing that Quest has been used as a facade for activities of the Moodys or any Receivership entities, or as a means to divert or conceal ownership of any assets. The only factual showing the Receiver has made here is that the Moodys and two Receivership entities transferred funds to Quest – the same showing the *Elmas Trading* court held was "insufficient" standing alone to bring an entity into the receivership there. *Id.* at 239. Further, here, unlike in *Elmas Trading*, countervailing evidence

is before the Court regarding both the legal status of Quest and the business purpose of the funds transferred to it. The funds that went to Quest were not mere transfers but investments for which valuable consideration was provided. Doc. 994 Ex. D-F. They were undertaken in the ordinary course of business and were appropriately documented. Doc. 994 Ex. D-F. Additionally, other investors, not affiliated with the Moodys or any Receivership entities, have invested in Quest in a total amount that is an order of magnitude larger than the investments at issue here. Ex. A ¶ 29.

In sum, the Receiver has failed to show, and could not show under the circumstances here, that Quest is an alter ego of the Receivership entities.

IV. The Receiver's potential claim under the Note does not entitle the Receiver to have Quest brought into the Receivership.

The Receiver argues in the alternative that he is entitled to have Quest brought into the Receivership because the Receivership holds a Note that is secured by a lien on the shares of Quest. Doc. 993 at 14-15. He provides no authority for the proposition that the Receiver's potential claim under the Note to a lien in the shares of Quest entitle the Receiver to have the Receivership expanded to include Quest. To the contrary, the terms of the Note provide the Receiver a potential claim against Quest, subject to all of the claims and defenses Quest would have against the original holder of the Note. It does not provide a basis for Quest to be made a part of the Receivership.

It is not clear from the Receiver's motion the basis on which the Receiver contends its potential claim against Quest under the Note entitle it to have Quest included in the Receivership without instituting an action against Quest. If the Receiver intends to suggest that the Court

could adjudicate the Receiver's potential claim through summary proceedings, the Receiver is mistaken. While district courts may use summary proceedings in granting relief in a receivership under some circumstances, "[s]ummary proceedings are inappropriate when parties would be deprived of a full and fair opportunity to present their claims and defenses." *Elliott*, 953 F.2d at 1566-67; *see also Ross*, 504 F.2d at 1144 (reversing disgorgement order where the "use of summary proceedings improperly deprived [subject of the order] of the opportunity to fully litigate the question of his liability"). Where a property owner would be "prejudiced by . . . summary proceedings" and would be "better able to defend [its] interests in a plenary proceeding," a summary procedure does not adequately protect the property owner's interests to satisfy due process. *Elliott*, 953 F.2d at 1567. Due process is violated where the use of summary proceedings denies the opposing party "discovery or an opportunity to present evidence." *Id.* at 1572.

Here, there are significant issues relating to the Receiver's potential claim under the Note that require access to the discovery process and opportunity to put on evidence that a plenary proceeding allows. For instance, as was the case in *Elliott*, 953 F.2d at 1572, here the circumstances surrounding the loans are relevant to the Receiver's potential claim. "[T]he authority of a receiver is defined by the entity or entities in the receivership." *Eberhard v. Marcu*, 530 F.3d 122, 132 (2d Cir. 2008). That is, a receiver "has no greater rights or powers than the corporation itself would have." *Id.* (quoting *Fleming v. Lind-Waldock & Co.*, 922 F.2d 20, 25 (1st Cir. 1990)). While the receiver may file lawsuits, it "stands in the shoes of the corporation and can assert only those claims which the corporation could have asserted." *Id.*

(quoting *Lank v. N.Y. Stock Exch.*, 548 F.2d 61, 67 (2d Cir. 1977)). Moreover, a receiver's "rights as a plaintiff are subject to the same claims and defenses as the received entity he represents." *Wuliger v. Manufacturers Life Ins. Co.*, 567 F.3d 787, 798-799 (6th Cir. 2009). That is, where the receivership entity would be barred from asserting a claim by a defense such as unclean hands, the receiver is subject to the same defense. *Id.* Likewise, where a claim is subject to a right of setoff if asserted by the receivership entity, setoff may be allowed when the claim is asserted by the receiver. *Elliott*, 953 F.2d at 1572.

Here, the Moodys had agreed that the Promissory Note would be extended indefinitely until Quest had raised the sums that were contemplated at the time the Promissory Note was made. Ex. A ¶ 24. Because Quest would be entitled to assert that modification of the agreement against the Moodys and their affiliated companies, it will be entitled to assert that defense against the Receiver. *See Wuliger*, 567 F.3d at 798-799. Similarly, Quest has a claim against the Moodys and their company, Viking Oil & Gas, LLC, for over $4.8 million. Ex. A ¶ 31-34. Quest is entitled to seek a setoff in that amount against any claim the Receiver asserts based on Viking Oil's investments in Quest. *Elliott*, 953 F.2d at 1572. Further, Quest viewed the Moodys, Viking Oil, and Valhalla as a single source of funding. Ex. A ¶ 30. While discovery will be required to determine whether Quest can establish that Viking Oil and Valhalla are alter egos of one another, or of the Moodys, if such a showing is made, Quest may be able to seek a setoff in the amount Viking Oil owes against any claim by the Receiver based on the Promissory Notes.

The Promissory Note created a preferred lien in favor of Valhalla on all of the then-issued shares in Quest. Quest does not dispute that the Receiver is entitled to sue Quest based on that lien, subject to Quest's defenses and any setoff Quest may be entitled to. Summarily including Quest in the Receivership, as the Receiver appears to be requesting, however, would deprive Quest of discovery and would not allow Quest a full and fair opportunity to put on evidence and assert its claims and defenses. The Receiver's motion should therefore be denied.

CONCLUSION

For these reasons, the Court should deny the Receiver's motion to expand the scope of the receivership to include Quest.

Respectfully submitted by:

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Counsel for Quest Energy Management Group, Inc.

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that on this the 15th day of April, 2013, I electronically filed the foregoing with the Clerk of the Court using the CM/ECF system, which will send a notice of electronic filing to all counsel of record.

/s/ Katherine Earle Yanes
Katherine Earle Yanes