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EXCEPTION

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ARIZONA CORPORATION COMMISSION
DOCKET CONTROL

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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

BOB STUMP, Chairman

GARY PIERCE

BRENDA BURNS

BOB BURNS

SUSAN BITTER SMITH

Arizona Corporation Commission

DOCKETED

SEP 2 2014

ORIGINAL

DOCKETED BY

In the matter of:

PATRICK LEONARD SHUDAK, a single man,

PROMISE LAND PROPERTIES, LLC, an Arizona
limited liability company,

and

PARKER SKYLAR & ASSOCIATES, LLC, an
Arizona limited liability company,

Respondents.

DOCKET NO. S-20859A-12-0413

**RESPONDENT PATRICK SHUDAK'S
EXCEPTIONS TO THE
RECOMMENDED OPINION AND
ORDER**

Respondent Patrick Leonard Shudak ("Shudak") respectfully submits his Exceptions to the Recommended Opinion and Order (the "ROO") issued in this case on August 22, 2014. Shudak respectfully requests that the Arizona Corporation Commission (the "Commission") issue a final decision that is consistent with these Exceptions, and that dismisses the claims against Shudak.¹

¹ Shudak expressly reserves his rights to a rehearing and to an appeal, in the event that an amended order is not issued.

1 **BACKGROUND**

2 From its inception through the issuance of the ROO, the Division’s above-captioned case
3 appears to be unprecedented. While the evidentiary and legal defects became apparent during
4 the hearing, the issuance of the ROO has created due process violations that underscore the
5 atypical nature of this entire proceeding.

6 **I. THE FACTS**

7 The case began with the Securities Division (the “Division”) alleging that Shudak, in his
8 individual capacity and as a control person of Parker Skylar & Associates, LLC (“Parker
9 Skylar”), violated the securities registration and securities fraud statutes by offering promissory
10 notes and membership units in Parker Skylar to 18 investors. Parker Skylar, in turn, was a
11 member of Cochise County 1900, LLC, which was organized for the purpose of acquiring and
12 developing approximately 1,900 acres near Bisbee, Arizona (the “Bisbee Property” or “Bisbee
13 Project”). The Bisbee Project began in 2008 and floundered like so many other real estate
14 projects in Arizona during the Great Recession. These facts are unremarkable.

15 The story’s trajectory changed dramatically in December 2009 – almost *five years ago* –
16 when the investors in the project, all of whom represented themselves as accredited investors,
17 took control of the company in charge of the development, removed the principals (including
18 Shudak), and voted to develop the project themselves instead of selling the land to recoup their
19 investments. Years later, after the applicable statutes of limitations would have barred any
20 purported private cause of action, the investors acknowledge that they made a “bad decision”
21 when they decided to develop the project themselves. This is not the fact-pattern of a typical
22 enforcement action. However, at least one investor convinced the Division otherwise.

23 **II. THE HEARING**

24 The fragile nature of this action became apparent during the hearing. The Division
25 introduced testimony from only three of the 18 investors – Martin Schwank, Craig Swandal, and
26 Steven Berendes, all of whom invested under such vastly different circumstances that no broad
27 conclusions with respect to the other 15 investors – who did not testify at the hearing – could be
28 gleaned. The Division also introduced testimony from two staff members – forensic accountant

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1 Andrea McDermitt-Fields and investigator Dulance Morin, who conceded that they did not have
2 evidence necessary to support all of the Division's claims.

3 The most disturbing aspect of the Division's case, and by extension the ROO, is the
4 often-repeated fabrication that there is evidence concerning what all the investors believed,
5 expected, knew, relied upon, or were told. That evidence simply does not exist. To fill-in all the
6 missing evidence, the Division offered nothing more than conjecture and hypothesis to support
7 its claims relating to the other investors.

8 With respect to the three investors who did testify, the Division failed to prove that any
9 fraud occurred. Schwank testified that he invested a total of \$361,000. *See* Exh. S-48. He
10 testified that he "became friendly" with Shudak in 2008. Tr. 25:10-20. At some point in time
11 after they became friends, the two discussed the Bisbee Project. Tr. 25:25-26:10. Schwank's
12 understanding was that Shudak was responsible for raising "up to \$2.5 million to finance the
13 purchase of the land and [to get] the property to plat." Tr. 33:10-13. Schwank's "due diligence"
14 consisted of reading the operating agreements for Cochise County 1900 and Parker Skylar,
15 visiting the site, and asking Alan Thome about the project. Tr. 90:3-92:8. Schwank understood
16 that Thome, not Shudak, was responsible for developing the Bisbee Project. Tr. 91:1-12. After
17 Schwank made his investment, he also knew that work was being done to get the plat approved.
18 Tr. 97:7-11.

19 Swandal testified that he invested \$300,000. *See* Exh. S-48. He learned about the Bisbee
20 Project from his "very close friend" Jim Peterson, an Arizona realtor. Tr. 215:14-25. It was
21 Peterson, not Shudak, who suggested that Swandal invest in the Bisbee project. Tr. 216:9-16.
22 Swandal does not recall what information he reviewed on the Bisbee Project before he decided to
23 invest, and was not provided with "a lot of specifics" about it. Tr. 218:21-219:11, 222:5-11.
24 Peterson did explain to Swandal that Thome would be developing the project and "vouched for
25 him," but Peterson did not speak with Thome before making his investment. Tr. 220:3-10,
26 225:7-13. Swandal "was in the midst of flying all over the world," and admits that
27 "unfortunately [he] didn't have a lot of time to do the diligence that [he] should have." Tr.
28 224:11-20. Instead, he relied on his attorney. Tr. 226:21-227:8.

1 Berendes testified that he invested \$100,000. *See* Exh. S-48. He was introduced to
2 Shudak through “a friend of a friend,” John Schnaible. Tr. 272:25-273:3. In return for his
3 investment, Berendes understood that he would receive a note that would bear 14% interest and
4 that he would get his interest and principal on the one year anniversary. Tr. 273:10-16.
5 Berendes has “no idea” if he is still a member of Parker Skylar, and does not “have much interest
6 in the LLC units.” Tr. 283:13-15, 284:4-16. He said that Shudak gave him “enough paper to
7 choke a horse,” but he was “only interested in one thing,” which was getting his money back
8 after one year with a 14% return. Tr. 280:2-10.

9 In sum, the testimony from the three investors reflects that little, or no, due diligence was
10 done before they made their investments, and there is no evidence that Shudak made the
11 representations that the ROO concludes he made.

12 The Division did not offer any testimony from the other 15 purported investors (Frank
13 Lamer, Tim Olp, John Schnaible, John McCardle, Jim Peterson, Craig Thomson, Jack Sandner,
14 Timothy Banghart, Gary Bates, Mitchell Lane, William Livingston, Frank Moran, Mick Manley,
15 Jerry Gruetzemacher, and Donald Van Hook). The record is devoid of any evidence of what
16 these 15 investors knew, or did not know, before they purportedly made their investments.

17 The Division also did not offer any testimony from Shudak. The Division did not ask to
18 depose or even interview Shudak during its investigation, and did not ask that Shudak appear to
19 testify at the hearing. There is no record anywhere of what Shudak said, or did not say, to all but
20 three of the investors. This void alone should have resulted in the dismissal of any claims related
21 to 15 of the 18 investors.

22 With respect to what documents the investors might have read, the record is similarly
23 undeveloped. The ROO finds that “[a]lmost all” – meaning *not* all – investors signed investment
24 purchase agreements, and that at least two investors signed documents that were “significantly
25 different” from the agreements used with other investors. ROO at ¶46 and fn. 45. Yet, the ROO
26 does not account for these variances in the record.

27 Throughout the hearing, ALJ Mark E. Stern repeatedly indicated his own skepticism
28 about the Division’s case, at one point telling the parties, “I don’t recall ever seeing something

1 quite like this.” Hearing Transcript (“Tr.”) 332:2-13.

2 **III. THE ROO**

3 The hearing occurred in June 2013. After waiting for more than a year, a
4 recommendation has been filed, but not by ALJ Stern, who presided over the hearing. Instead,
5 the recommendation has been filed by ALJ Belinda A. Martin. ALJ Martin’s ROO contains a
6 number of findings unsupported by the evidence. Those findings are discussed below.
7 However, more fundamentally, the ROO runs afoul of the Commission’s own regulations
8 governing practice and procedure, and violates Shudak’s basic due process rights in at least two
9 respects. The Commission’s rules require that when a case is heard by a hearing officer, the
10 same hearing officer shall prepare the recommendation. The wisdom of those rules is illustrated
11 by the due process violations that occurred here, where the rules were not followed. ALJ Martin
12 did not have an opportunity to observe and weigh the credibility of the testimony from any of the
13 witnesses, and – perhaps as a result – the ROO recommends findings of fact and conclusions of
14 law that are based on charges never made by the Division or contested during the hearing. It is
15 well-settled that these transgressions have resulted in due process violations.

16 At this late stage, the Commission can adopt Exceptions that effectively nullify the
17 multitude of issues raised by this proceeding. Alternatively, if the Commission does not adopt
18 such Exceptions, the case is destined for a rehearing or appeal.

19 **DISCUSSION**

20 **I. THE COMMISSION HAS VIOLATED SHUDAK’S DUE PROCESS RIGHTS**
21 **AND FAILED TO COMPLY WITH ITS OWN REGULATIONS GOVERNING**
22 **PRACTICE AND PROCEDURE**

23 Administrative agencies must conduct their hearings “consistently with fundamental
24 principles which inhere in due process of law.” *Cash v. Indus. Comm’n*, 27 Ariz. App. 526, 532,
25 556 P.2d 827, 833 (App. 1976) (setting aside an award of the Industrial Commission of Arizona,
26 where the respondent was not permitted to introduce testimony of his medical expert at the
27 hearing). The determination of whether due process has been afforded by an administrative
28 agency “requires analysis of the governmental and private interests that are affected.” *Mathews*
v. Eldridge, 424 U.S. 319, 334-35 (1976). At bottom, the parties must have been afforded “the

1 opportunity to be heard ‘at a meaningful time and in a meaningful manner.’” *Id.* at 333 (internal
2 citations omitted).

3 Here, the Commission has violated Shudak’s due process rights in at least two respects.
4 First, the ROO has been drafted by a different hearing officer than who presided over the
5 hearing. Swapping ALJs in these proceedings violate well-settled due process laws, and the
6 Commission’s own regulations. Further, as detailed below, ALJ Martin’s recommendation
7 cannot be reconciled with the comments ALJ Stern made during the hearing. Second, illustrating
8 the inherent prejudice in allowing a different ALJ to recommend findings of fact and conclusions
9 of law, the ROO improperly raises charges that were never part of the Division’s case, never
10 argued at the hearing, and never discussed in the parties’ post-hearing briefs. As a result, Shudak
11 did not have any opportunity to defend himself against these new charges. These fundamental
12 procedural improprieties violate Shudak’s due process rights.

13 **A. The Commission Has Failed to Comply with its Own Rules of Practice and
14 Procedure**

15 Under A.A.C. R14-3-109(A), every hearing shall be held “before one or more
16 Commissioners, one or more Hearing Officers, or any combination thereof.” In this case, there
17 was one Hearing Officer, ALJ Stern. The rules of practice require that “[i]n a proceeding heard
18 by *a Hearing Officer, the Hearing Officer* shall prepare his recommendation which may be in
19 the form of an opinion and order, unless otherwise directed by the Commissioners. Such
20 recommendation by *the Hearing Officer* shall become part of the Docket Such proposed
21 order shall include recommended findings, conclusions, and order, which may be narrative form
22 at the discretion of *the Hearing Officer.*” A.A.C. R14-3-110(B) (emphasis added). Thus, the
23 rules unequivocally require that when a hearing is heard by a Hearing Officer, that Hearing
24 Officer shall prepare the recommendation.

25 The Commission’s rules conform with the basic precepts of administrative law. For
26 example, it is well-established, particularly in a case like this one where witness testimony is at
27 issue, that “a hearing examiner making a recommendation to a reviewing board, agency or court
28 must actually hear and observe the witnesses.” *Adams v. Indus. Comm’n of Ariz.*, 147 Ariz. 418,

1 420, 710 P.2d 1073, 1075 (App. 1985) (setting aside award of the Industrial Commission of
2 Arizona where administrative law judge who did not preside over hearing made findings); *see*
3 *also Ohlmaier v. Indus. Comm'n*, 161 Ariz. 113, 118, 776 P.2d 791, 796 (1989) (“In order to
4 give impartial and complete credence to evidence, the one who decides the issue should be the
5 one who hears the evidence.”). This rule exists because “the predicate upon which our deference
6 is given to the finder of fact is the assumption that he has indeed had the opportunity to look the
7 witness in the eye and reach a conclusion with respect to his veracity or lack thereof.” *Id.*

8 When witness testimony is an issue, a “substitute” hearing officer who did not preside
9 over the hearing should not be the one making findings or a recommendation. *See Adams*, 147
10 Ariz. at 420, 710 P.2d at 1075. Indeed, the general rule has been stated as follows:

11 [T]he principle which should govern substitution of hearing officers is the simple
12 one that demeanor of witnesses should not be lost from the case. Whoever
13 observes the demeanor must report it to the decision makers. If demeanor is
unimportant because *all* the crucial evidence is documentary, no such report is
needed.

14 *Id.* (emphasis added) (quoting K. Davis, *Administrative Law Treatise* § 17:17 (2d ed. 1980)). If
15 a recommendation is permitted to be made based on “the cold record,” then “the integrity of the
16 legal process not only falters, it fails.” *Id.* “[T]he conflict [must] be resolved by something more
17 personal than a sterile resort to pages of hearing transcripts.” *Id.*

18 Here, the Division clearly did not rely solely upon a “cold record” in presenting its case.
19 It relied heavily on its witnesses to attempt to connect threads of incomplete documentary
20 evidence. ALJ Stern presided over the entire three-day proceeding, heard the evidence, cross-
21 examined witnesses, directed questions to counsel, and ruled on numerous evidentiary
22 objections. Perhaps most importantly, as discussed below, ALJ Stern also repeatedly questioned
23 on the record the credibility of witness testimony. ALJ Martin, who did not hear the evidence,
24 cross-examine any witnesses, direct any questions to counsel, or rule on any evidentiary
25 objections, has authored recommendations simply based on the “cold record.” ALJ Martin’s
26 recommendations cannot be reconciled with ALJ Stern’s comments at the hearing, let alone the
27 evidence. The ROO violates the Commission’s own rules, and violates Shudak’s rights to due
28 process.

1 **B. The ROO Improperly Recommends Findings of Fact and Conclusions of**
2 **Law Based on New Charges**

3 The ROO also violates Shudak’s due process rights, because ALJ Martin raises new
4 charges that were neither identified in the Notice nor argued by the parties during the hearing.
5 “The essence of due process is the requirement that a person in jeopardy of serious loss (be
6 given) notice of the case against him and opportunity to meet it.” *Mathews*, 424 U.S. at 348
7 (1976) (internal citations omitted). Thus, where a hearing officer finds violations “based on
8 grounds not alleged in [the agency’s] notice,” it is a violation of due process. *See Carlson v.*
9 *Arizona State Pers. Bd.*, 214 Ariz. 426, 432, 153 P.3d 1055, 1061 (App. 2007) (vacating and
10 remanding trial court judgment affirming decision of the Arizona State Personnel Board, where
11 the hearing officer’s findings were “based on conduct never alleged” in the Arizona Department
12 of Environmental Quality’s notice).

13 The courts have long held that in administrative proceedings “no person may lose
14 substantial rights because of wrongdoing shown by the evidence, but not charged.” *Murray v.*
15 *Murphy*, 24 N.Y. 2d 150, 157, 247 N.E. 2d 143, 147 (1969); *see also Carlson*, 214 Ariz. at 432,
16 153 P.3d at 1061 (collecting cases). A respondent to an administrative proceeding has a due
17 process right “to assume that the hearing will be limited to the charges made.” *Id.* “His lawyer
18 is likewise entitled to prepare for the hearing in reliance that, after the hearing is concluded the
19 charges will not be switched.” *Id.* “[I]n such a ‘switching’ situation, prejudice is presumed,”
20 and due process will be deemed to have been violated. *Carlson*, 214 Ariz. at 432, 153 P.3d at
21 1061.

22 Here, the Division’s fraud claim always has been based on four grounds: (i) the alleged
23 oversubscription of membership units; (ii) the alleged misuse of investor funds, which were to be
24 used for the development of the Bisbee Project; (iii) the alleged failure to disclose to investors a
25 loan and security interest from a private lender; and (iv) the alleged misrepresentation by Shudak
26 that he had the expertise and experience to raise sufficient capital to fund CC 1900’s operations
27 while failing to disclose “to several” investors that Shudak had been sued by several creditors.
28 *See Notice at ¶57.* Those four grounds were identified in the Notice, litigated during the hearing,

1 and then further debated in the parties' post hearing briefs. *See* Division's Post-Hearing Reply
2 Brief at 10 ("The Division Brief discusses four distinct frauds ..."). While the parties disagreed
3 about the evidence, they never disagreed over what the alleged "four distinct frauds" were.
4 Inexplicably, although the ROO acknowledges "the four different fraudulent acts," ROO at ¶137,
5 the ROO strays from these bases, and introduces new charges that were not included in the
6 Division's Notice, and that neither side had the opportunity to contest:

7 First, ALJ Martin correctly acknowledges that the Division failed to prove that Shudak
8 misused investor funds. *See, e.g.*, ROO at ¶82 ("There is no evidence demonstrating for what
9 purposes Mr. Shudak used the PSA funds ..."), and ¶149 ROO ("The Division did not submit
10 any direct evidence that the funds were used for impermissible purposes after they were
11 transferred."). These findings should have ended the analysis in favor of Shudak on this charge.

12 Instead of concluding the analysis, the ROO *switches* the analysis, and finds that Shudak
13 committed securities fraud by adding a co-signatory to the PSA's bank account, and by
14 commingling investor funds with non-investor funds. ROO at ¶¶151-158. Neither of these
15 charges is found in the Division's Notice. The latter argument is particularly perplexing, because
16 the ROO acknowledges elsewhere that the record concerning the movement of funds "is not
17 substantiated or supported, and is, therefore, unreliable" ROO at ¶84. To compound matters,
18 the ROO falsely finds that Shudak "fail[ed] to advise investors that the PSA account and investor
19 funds were being handled in a manner contrary to that represented to investors under the
20 Operating Agreement" ROO at ¶158. The record is devoid of evidence supporting that
21 finding. None of the witnesses were asked about signatories on the account or the alleged
22 commingling of funds, because that was not a bases for the Division's securities fraud claim.
23 The findings of fact and conclusions of law relating to this new charge for fraud should be
24 stricken from any order.

25 Second, the ROO recasts the Division's claim pertaining to Shudak's ability to raise
26 capital for the Bisbee Project into a materially different claim. The ROO finds that Shudak
27 misrepresented to investors that "he also had the financial wherewithal to bear the total risk of
28 economic loss if the Project failed." ROO at ¶165. There is no evidence in the record

1 concerning Shudak's financial wherewithal or any commitment that he would "bear the total risk
2 of economic loss if the Project failed." These fact issues were never part of the Division's case.

3 The Division's claim always has been that Shudak represented that he had the
4 qualifications to raise capital sufficient to fund CC 1900's operations. See Notice at ¶57. On
5 that claim, as discussed below, there is no evidence that Shudak made the representation to all of
6 the investors; and, even if he had, the record demonstrates that he could raise capital sufficient to
7 fund CC 1900's operations. This part of the Division's fraud claim should have been denied.

8 These due process violations alone warrant material amendments to the ROO. But there
9 are additional grounds warranting amendments.

10 **II. THE DIVISION'S FRAUD CLAIMS FAIL**

11 As discussed, the ROO mischaracterizes, sometimes blatantly, the Division's fraud
12 charges. The analysis should track the allegations raised in the Division's Notice. If the
13 Commission stays within the scope defined therein, the evidence and law simply fail to support
14 the recommendations.

15 **A. Allegation: Shudak sold at least 29% of Parker Skylar membership interests to investors after 100% of Parker Skylar membership interests had been assigned.**

16
17 The evidence does not support the allegation that Shudak sold more than 100% of Parker
18 Skylar's membership interests. See Notice at ¶57(a). The ROO's analysis also illustrates why it
19 is a violation of due process to allow an ALJ who did not preside over the hearing to make the
20 recommended order.

21 The evidence concerning the alleged oversubscription was, if nothing else, confusing and
22 incomplete. During the hearing, ALJ Stern aptly characterized the Division's evidence on this
23 issue as "pretty questionable" and "really roughshod." Tr. 413:13-14, 414:2-4. In stark contrast
24 to ALJ Stern's contemporaneous remarks on the testimony and documentary evidence, ALJ
25 Martin has concluded that "the Division presented more than sufficient evidence demonstrating
26 that Mr. Shudak oversubscribed the offering." ROO at ¶142. It is impossible to reconcile these
27 two opinions expressed by two different hearing officers.

28 According to the Division's own records, Shudak only sold 88 membership units in

1 Parker Skylar. *See* Exh. S-48. There is no evidence that any consideration was paid for the other
2 45 units that are part of the Division's calculation. *See id.* Indeed, Morin, the Division's
3 investigator, testified that "[a]fter several interviews" the Division found that Schnaible, Lamer,
4 McCardle, and Peterson did not invest any cash in Parker Skylar. Tr. 399:12-401:7. The
5 Division attributes 35 of the "133" membership units to those four individuals. *See* Exh. S-48.
6 Thus, based on the Division's own admissions, once those 35 units are deducted from the total,
7 the number of units sold is under 100.

8 There is evidence that the total number of units sold should be reduced even further. The
9 Division introduced evidence showing that one of the investors, Tim Olp, invested money with
10 Parker Skylar and purportedly received eight membership units, but he also received money back
11 on several occasions. *See* Exhs. S-36, S-38, and S-48. ALJ Stern asked Morin if he knew how
12 McCardle, Schnaible, Lamer, Peterson, or Olp got their membership units, and Morin confessed
13 that he did not know. Tr. 406:17-407:20. Morin conceded that he was unable to confirm how
14 much money was invested and paid to Parker Skylar, and he could not confirm whether any
15 consideration was paid for the purported membership interests in Parker Skylar:

16 Q. And you don't know if there was any consideration paid for any of these
17 purported investors if you don't have evidence of monies being received by
18 Parker Skylar, correct?

19 A. That's correct.

20 Tr. 392:3-7; *see also* Tr. 390:23-392:7; Exh. S-48. So, while the Division alleged that Shudak
21 assigned 133 out of a possible 100 membership units in Parker Skylar, the record is devoid of
22 evidence establishing the number of membership units actually sold. ALJ Stern commented on
23 that void. *See* Tr. 413:13-14, 414:2-4. The ROO glosses over it.

24 **B. Allegation: Shudak represented to investors that all investor funds would be**
25 **transferred to Cochise County 1900 to be used for the purchase of the Bisbee**
26 **Property and expenses related to obtaining a final plat for the Bisbee Project,**
27 **when in fact, on several occasions, the money was not transferred to or used**
28 **for the benefit of Cochise County 1900.**

29 Once again, the ROO's analysis illustrates how Shudak's due process rights have been
30 violated when a different ALJ is tasked with making recommendations based on a hearing the
31 ALJ did not preside over. During the hearing, ALJ Stern offered the most accurate description of

1 the evidence on how investor funds were used, when he observed: “There’s a lot of money came
2 in here and lot of money went different places, it doesn’t always – you can’t tell.” Tr. 338:10-14.
3 As alluded to above, the ROO reaches the same conclusion, but then veers the analysis in a
4 completely different – and improper – direction.

5 Of the 18 alleged Parker Skylar investors, the record is devoid of any evidence of what
6 Shudak said, or did not say, to 15 of them. Similarly, the record is devoid of any evidence of
7 what those same 15 investors knew, or did not know, before they purportedly made their
8 investments.

9 Even assuming Shudak did make the alleged representations, there is no evidence that
10 any such representations were false. The Division failed to prove that any of the investor funds
11 were misdirected or used for anything other than expenses related to the Bisbee Project.
12 McDermitt-Fields, the Division’s forensic accountant, did not do any analysis on how the money
13 raised was used. Tr. 334:6-11. She purported to trace only two of the investments, but even with
14 respect to those two investments, she did not know if any of the money was redirected to cover
15 expenses unrelated to the project. Tr. 334:6-341:1. In fact, when asked if all the funds could
16 have been used for legitimate purposes related to the Bisbee Project, McDermitt-Fields
17 acknowledged that she just did not know. Tr. 340:20-341:1.

18 Similarly, Schwank acknowledged that: (i) Parker Skylar could have paid development
19 expenses directly; (ii) he does not know how much money was spent on the Bisbee Project; and
20 (iii) he cannot account for all the money deposited, or not deposited, in the Cochise County
21 account. Tr. 126:5-129:2. The record is silent on this issue.

22 **C. Allegation: Shudak did not disclose that a private lender had taken steps to**
23 **perfect its security interest in all of Parker Skylar’s assets and that the lender**
24 **considered Parker Skylar in default of its obligations to the lender.**

25 The evidence does not support the allegation that Shudak failed to disclose that a private
26 lender had taken steps to perfect its security interest in all of Parker Skylar’s assets and that the
27 lender considered Parker Skylar in default of its obligations to the lender. *See* Notice at 57(c).
28 This allegation, which concerns an apparent loan that Nascent Investments, LLC (“Nascent”) made on May 22, 2008, has several fundamental evidentiary and factual deficiencies. *See* Exh.

1 S-50.

2 First, as discussed, the record is devoid of any evidence of what Shudak said, or did not
3 say, to 15 of the Parker Skylar investors. Similarly, the record is devoid of any evidence of what
4 those same 15 investors knew, or did not know, before they purportedly made their investments.
5 The ROO simply ignores this void in the record, and concludes in summary fashion that
6 “[i]nvestors should have been advised of the perfected security interest prior to making their
7 investments” ROO at ¶164.

8 Second, the Parker Skylar Operating Agreement fully disclosed that Shudak, as Manager,
9 had the authority to borrow money on behalf of the company. Under paragraph 6.3 of the Parker
10 Skylar Operating Agreement, the Manager “has the power, on behalf of the Company, without
11 further authorization from the Members, to do all things necessary or convenient to carry out the
12 business and affairs of the Company, including, without limitation ... (d) entering into contracts
13 and guarantees; incurring of liabilities; borrowing money, issuance of notes, bonds, and other
14 obligations, and the securing of any of its obligations by mortgage or pledge of any of its
15 Property or income.” See Exh. S-56 at p. 8, ¶6.3.

16 Third, the record is devoid of any evidence showing: (i) when Nascent took steps to
17 perfect its security interest in Parker Skylar’s assets; (ii) when, if at all, Shudak knew that
18 Nascent took steps to perfect its security interest in Parker Skylar’s assets; (iii) when Nascent
19 considered Parker Skylar in default; and (iv) when, if at all, Shudak knew that Nascent
20 considered Parker Skylar in default. See *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569
21 (9th Cir. 1990) (finding that “the danger of misleading buyers must be actually known or so
22 obvious [to the seller] that any reasonable man would be legally bound as knowing, and the
23 omission must derive from something more egregious than even ‘white heart/empty head’ good
24 faith”) (internal quotations omitted); *Golden Rule Ins. Co. v. Montgomery*, 435 F. Supp. 2d 980,
25 983 (D. Ariz. 2006) (recognizing that there can be “no fraud where the omitted information was
26 not within the [defendant’s] personal knowledge”); *In re MicroStrategy, Inc. Secs. Litig.*, 148 F.
27 Supp. 2d 654, 665-66 (E.D. Va. 2001) (stating that for securities fraud liability, plaintiffs must
28 demonstrate that “defendants knowingly or recklessly misstated or omitted the alleged material

1 facts”).

2 Fourth, according to the Division’s calculations, three of the investors (Frank Lamer, Tim
3 Olp, and Craig Swandal) invested *before* the loan was made, so there was nothing to disclose
4 with respect to those investments. *See* Exh. S-48. The ROO acknowledges this fact, but falsely
5 argues that a covenant in the Assignments that membership interests were free and clear of liens
6 and encumbrances somehow includes a covenant about the potential for future encumbrances.
7 *See* ROO at ¶162. The Assignments contain no such covenants.

8 Fifth, the investors all represented that they had access to whatever information they
9 deemed necessary and that they conducted their own due diligence. *See* Exhs. S-16 through S-33.
10 There was no evidence concerning the due diligence conducted by 15 of the 18 investors. On
11 June 6, 2008, Nascent recorded a UCC Financing Statement, listing Parker Skylar as the debtor
12 and reflecting that the financing statement covered all of Parker Skylar’s assets. *See* Exh. S-15.
13 The Division’s fraud claim cannot rest upon the publicly disclosed loan. *See In re Progress*
14 *Energy, Inc.*, 371 F. Supp. 2d 548, 552-53 (S.D. N.Y. 2005) (recognizing that it is “well-
15 established law that securities laws do not require disclosure of information that is publicly
16 known”); *see also Drobbin v. Nicolet Instrument Corp.*, 631 F. Supp. 860, 891 (S.D. N.Y. 1986)
17 (stating that “securities laws were not enacted to protect sophisticated [investors] from their own
18 errors of judgment,” and finding that where an investor fails to conduct a background check on
19 seller, investor could not blame seller for failure to disclose his criminal convictions and
20 involvement in litigation).

21 **D. Allegation: Shudak represented that he was qualified and had expertise and**
22 **experience to raise capital sufficient to fund Cochise County 1900’s**
23 **operations, and failed to disclose to several investors that several of Shudak’s**
24 **creditors had sued Shudak.**

25 The evidence does not support the allegation that Shudak represented that he was
26 qualified and had expertise and experience to raise capital sufficient to Cochise County 1900’s
27 operations, or that he failed to disclose to several investors that several of Shudak’s creditors had
28 sued him. *See* Notice at 57(d).

Again, the record is devoid of any evidence of what Shudak said, or did not say, to 15 of

1 the Parker Skylar investors. The ROO simply cites to language in the CC1900 Operating
2 Agreement. ROO at ¶169. The investors were not members of CC1900, and there is no
3 evidence that investors received or relied upon the CC1900 Operating Agreement. Similarly, the
4 record is devoid of any evidence of what 15 investors knew, or did not know, before they
5 purportedly made their investments. Of the three investors who did testify, *none* of them
6 testified that Shudak represented himself as “qualified” or that he “had expertise and experience
7 to raise capital sufficient to fund Cochise County 1900’s operations.”

8 Since the Division chose to bring its case without questioning Shudak, there also is no
9 record of whether Shudak knew that he had been sued by any of his creditors. *See Hollinger*,
10 914 F.2d at 1569 (finding that “the danger of misleading buyers must be actually known or so
11 obvious [to the seller] that any reasonable man would be legally bound as knowing, and the
12 omission must derive from something more egregious than even ‘white heart/empty head’ good
13 faith”) (internal quotations omitted); *Golden Rule Ins. Co.*, 435 F. Supp. 2d at 983 (recognizing
14 that there can be “no fraud where the omitted information was not within the [defendant’s]
15 personal knowledge”); *In re MicroStrategy, Inc. Secs. Litig.*, 148 F. Supp. 2d at 665-66 (stating
16 that for securities fraud liability, plaintiffs must demonstrate that “defendants knowingly or
17 recklessly misstated or omitted the alleged material facts”). The cases against Shudak all
18 resulted in default judgments, which were entered on December 23, 2008, February 24, 2009,
19 March 6, 2009, June 10, 2009, well after most of the alleged investments were made. *See Exhs.*
20 S-40a, S-41a, S-42a, S-43a,

21 As discussed above, the ROO implicitly acknowledges this void in the evidence, but then
22 recommends findings that go beyond the scope of the Notice.

23 **E. Allegation: Shudak induced an Arizona couple to purchase a note in the**
24 **principal amount of \$200,000 by using a security agreement granting a**
25 **security interest in Parker Skylar for 50% of Parker Skylar, when at the**
26 **time, Shudak had transferred 132.5% of Parker Skylar.**

27 The evidence does not support the allegation that Shudak induced an Arizona couple, the
28 Van Hooks, to purchase a note in the principal amount of \$200,000 by using a security
agreement granting a security interest in Parker Skylar for 50% of Parker Skylar, when at the

1 time, Shudak had transferred 132.5% of Parker Skylar. *See* Notice at 57(e).

2 The Division presented virtually no evidence concerning the Van Hooks' note. The *only*
3 testimony cited by the ROO is from Morin, who simply testified that Mr. Van Hook told him that
4 he understood that the loan would "go towards the land development," that he made the
5 \$200,000 loan, and he did not receive any payments in return. *See* ROO at ¶70; Tr. at 382-383.
6 There was no questions asked, and no answers given, about what, if anything, Shudak
7 represented to the Van Hooks or what they relied upon before making their loan.

8 As a threshold matter, the Van Hooks' note is not a security under Arizona law. *See*
9 *State v. Tober*, 173 Ariz. 211, 841 P.2d 206 (1992). In *Tober*, the Arizona Supreme Court held
10 that for purposes of determining whether a note is a "security" under the registration
11 requirements of A.R.S. §§ 44-1841 and 44-1842, the courts must look to A.R.S. §§ 44-1843, 44-
12 1843.01, and 44-1844, which describe exempt notes and exempt transactions in notes. *Tober*,
13 173 Ariz. at 213, 841 P.2d at 208. There is no evidence that the Van Hooks' note was anything
14 other than a single, private transaction that was not part of any public offering. Therefore, the
15 note qualifies as an exempt transaction under A.R.S. § 44-1844, and is not a security under
16 *Tober*.

17 Second, even if the note is a security under Arizona law, there is no evidence of fraud.
18 The Van Hooks did not testify at the hearing, no testimony from them was introduced at the
19 hearing, and the record is devoid of any evidence of what Shudak said, or did not say, to the Van
20 Hooks. Similarly, the record is devoid of any evidence of what the Van Hooks knew, or did not
21 know, before they purportedly made their loan. Again, the ROO makes findings in this regard
22 that are unsupported by the record.

23 **III. THE DIVISION'S REGISTRATION CLAIM FAILS**

24 The ROO's analysis of the Division's registration claims fails for the same reasons that
25 its fraud analysis fails. The due process violations cover all the charges, and the same voids in
26 record exist.

27 The evidence does not support the Division's allegations that Shudak violated the
28 registration requirements of A.R.S. §§ 44-1841 and 44-1842. The investments were part of a

1 private offering and, therefore, exempt from registration under A.R.S. § 44-1844(A)(1). In
2 determining whether investments are part of a private offering and, therefore, exempt from the
3 registration requirements, courts consider the following factors: (1) the number of offerees; (2)
4 the sophistication of the offerees; (3) the size and manner of the offering; and (4) the relationship
5 of the offerees to the issuer. *See Mary S. Krech Trust v. The Lakes Apartments*, 642 F.2d 98, 101
6 (5th Cir. 1981). Here, each of these factors reflects that the investments were part of a private
7 offering:

8 **A. The Number of Offerees**

9 There is no rigid limit to the number of offerees to whom an issuer could make a private
10 offering. *See SEC v. Ralston Purina Co.*, 346 U.S. 119, 125 (1953). While the number of
11 offerees, itself, is not decisive, *Doran v. Petroleum Mgmt. Corp.*, 545 F.2d 893, 901 (5th Cir.
12 1977), “the more offerees, the more likelihood that the offering is public.” *See Hill York Corp. v.*
13 *Am. Intern. Franchises, Inc.*, 448 F.2d 680, 688 (5th Cir. 1971). Here, the evidence shows that
14 there were only 17 investors, and then an entirely separate loan involving Mr. Van Hook. This
15 evidence supports the finding that the investments were part of a private offering and, therefore,
16 exempt from registration. *See Krech Trust*, 642 F.2d at 102-103 (finding offering to be private
17 where there were 15 offerees); *see also Doran*, 545 F.2d at 901 (recognizing that the difference
18 between one and eight offerees is “relatively unimportant” to the private offering analysis).

19 **B. The Sophistication of the Offerees**

20 The Division introduced evidence showing that the offerees signed Investor Suitability
21 Questionnaires indicating that they were all accredited investors, and represented in the
22 Investment Purchase Agreements that they, among other things: (i) received and reviewed the
23 information provided to them; (ii) had a reasonable opportunity to ask questions and all questions
24 were answered to their satisfaction; (iii) conducted whatever investigation they deemed
25 necessary; (iv) evaluated the merits and risks of the investment; and (v) understood that the
26 investment was speculative and involved certain risks. *See Exhs. S-16 through S-33*. Thus,
27 based on their own admissions, the offerees were all sophisticated. This same evidence also
28 supports the finding that the investments were part of a private offering and, therefore, exempt

1 from registration. *See Krech Trust*, 642 F.2d at 102-103 (finding offering to be private where
2 investors completed questionnaires stating their “net worth and financial sophistication”).

3 **C. The Size and Manner of the Offering**

4 If an offering is small and is made directly to the offerees “rather than through the
5 facilities of public distribution such as investment bankers or the securities exchanges,” a court is
6 more likely to find that it is private. *See Hill York Corp.*, 448 F.2d at 689. Here, each of the
7 offerees acknowledged in their Investment Purchase Agreement that the solicitation was
8 “directly communicated to me and any Advisors ..., [and] [a]t no time was I presented with or
9 solicited by or through any leaflet, public promotional meeting, circular, newspaper or magazine
10 article, radio or television advertisement or any other form of general advertising” *See Exhs.*
11 S-16 through S-33 (Investment Purchase Agreement, Additional Terms and Conditions, ¶1(i)).
12 Given the relatively small nature of the offering, and the private manner of the solicitations, this
13 factor further supports the finding that the investments were part of a private offering and,
14 therefore, exempt from registration. *See Krech Trust*, 642 F.2d at 102-103 (finding offering to
15 be private where offering was made through brokers who directly communicated with only a
16 select group of investors).

17 **D. The Relationship Between the Issuer and the Offerees**

18 As discussed above, each of the offerees acknowledged that they were given access to
19 whatever information about the issuer they deemed necessary. *See supra* pp. 15-16. Therefore,
20 this factor supports the finding that the investments were part of a private offering and, therefore,
21 exempt from registration. *See Krech Trust*, 642 F.2d at 102-103 (finding offering to be private
22 where offerees were given the opportunity to ask questions and review relevant documents).
23 Because each of the above factors reflects that the investments were part of a private offering,
24 the investments were exempt from registration under A.R.S. § 44-1844(A)(1). The Division’s
25 registration claim, therefore, fails.

26 **IV. THE DIVISION IS NOT ENTITLED TO A RESTITUTION AWARD**

27 Because the Division failed to prove that there was a misuse of funds and that Shudak
28 improperly received any funds, the Division’s claim for restitution is inherently flawed.

1 The recommended restitution award illustrates, yet again, the due process issues created
2 by replacing the ALJ after the hearing. During the hearing, ALJ Stern described the obvious
3 problem with the Division's restitution calculations as follows:

4 I just still find it somewhat – I don't know what a good term would be. Usually
5 when you want to order an amount to be paid in restitution, you have a dollar
6 amount that you know is valid and it's been proven. Here we have claims of
7 investments, but no track of the money. ... So, we're not entirely sure if, in fact,
8 the monies were invested. ... I don't know, I don't recall ever seeing something
9 quite like this.

10 Tr. 332:2-13. Despite ALJ Stern's acknowledged concerns regarding the Division's proposed
11 restitution calculations, ALJ Martin, who was not present to weigh the credibility of the
12 Division's witnesses called to testify about the restitution calculations, adopted the Division's
13 proposed amount, with a reduction of \$90,500 because of insufficient evidence for one of the
14 investments. ROO at ¶185. ALJ Martin's analysis cannot be reconciled with ALJ Stern's
15 comments on the record.

16 The restitution award also fails to comply with Arizona law. Section 44-2032 of the
17 Arizona Securities Act (the "Act") provides that where a party has violated the Act, the ACC
18 may require the party to "provide restitution." See A.R.S. § 44-2032. The ACC must determine
19 the necessity for, and amount of, such restitution consistent with the well-defined meaning of
20 restitution under Arizona law. See *McIntyre v. Mohave Cnty.*, 127 Ariz. 317, 318 620 P.2d 696,
21 698 (1980) (recognizing that where it does not appear from the context that a different meaning
22 is intended, "[w]ords and phrases in statutes shall be given their ordinary meaning").

23 Under Arizona law, restitution is awarded where "it would be inequitable or unjust" for a
24 party to retain a "benefit" from another without compensation. See *Murdock-Bryant Constr.,*
25 *Inc. v. Pearson*, 146 Ariz. 48, 54, 703 P.2d 1197, 1203 (1985). The "mere receipt of a benefit is
26 insufficient" to justify restitution. See *id.* The purpose of restitution in circumstances such as
27 these is to "eliminate profit from wrongdoing, while avoiding, so far as possible, the imposition
28 of a penalty." See Restatement (Third) of Restitution and Unjust Enrichment § 51(4); see also
Webster v. Culbertson, 158 Ariz. 159, 162, 761 P.2d 1063, 1066 (App. 1996) (recognizing that in
the absence of law to the contrary, Arizona follows the Restatement). Therefore, where, as here,

1 “restitution is intended to strip [a party] of a wrongful gain,” restitution is calculated by
2 determining “the amount of the profit wrongfully obtained.” See Restatement (Third) of
3 Restitution and Unjust Enrichment § 49(4); see also *Amerco v. Shoen*, 184 Ariz. 150, 155, 907
4 P.2d 536, 541 (App. 1995) (finding the restitution due to be the amount of improper gains). The
5 party seeking restitution has the “burden of producing evidence permitting at least a reasonable
6 approximation of the amount of the wrongful gain.” See Restatement (Third) of Restitution and
7 Unjust Enrichment § 51(5)(d).

8 The record is devoid of any evidence that Shudak benefitted – let alone wrongfully
9 obtained profits – from the investments. As the ROO concedes, there is no evidence that any of
10 the funds paid by the investors: (i) were received by Shudak (or Parker Skylar); (ii) failed to go
11 towards the Bisbee Project; or (iii) were used by Shudak (or Parker Skylar) for anything other
12 than expenses related to the Bisbee Project. Moreover, even if the ACC finds that Shudak has
13 benefitted in some way, the Division still is not entitled to restitution in the amount that it
14 apparently seeks. The Division’s recovery in restitution is limited to “the amount of profit
15 [Shudak has] wrongfully obtained.” See Restatement (Third) of Restitution and Unjust
16 Enrichment § 49(4); see also *Amerco*, 184 Ariz. at 155, 907 P.2d at 541. The Division has not
17 produced any evidence permitting even a “reasonable approximation” of wrongfully obtained
18 profit.

19 **V. THE COMMISSION LACKS GROUNDS TO IMPOSE ADMINISTRATIVE**
20 **PENALTIES**

21 The ROO proposes an administrative penalty in the amount of \$150,000. ROO at ¶187.
22 For the reasons discussed herein, the record does not support the imposition of any penalties.
23 Most certainly, there is no evidence that Shudak committed 30 different violations (30 x \$5,000
24 = \$150,000). The imposition of penalties should be stricken from the final decision.
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CONCLUSION

For the foregoing reasons, Shudak respectfully requests that the Commission issue a decision that dismisses the claims against Shudak, containing the following Exceptions to the ROO:

1. Deletes all findings of fact and conclusions of law pertaining to the 15 investors who did not testify.
2. Deletes all language purporting to constitute findings of fact that Shudak violated A.R.S. § 44-1991.
3. Deletes all language purporting to constitute findings of fact that Shudak violated A.R.S. §§ 1841 or 1842.
4. Deletes all language regarding control person liability since there is no grounds for primary liability.
5. Deletes all recommended “conclusions” contained in the ROO. ROO at ¶¶ 122-132, 142-144, 149-158, 162-164, 169-171, 174-175.
6. Deletes all recommended findings of fact and conclusions of law that relate to charges not contained in the Division’s Notice.
7. Deletes all recommended findings of fact and conclusions of law relating to the award of restitution.
8. Deletes all recommended findings of fact and conclusions of law relating to the imposition of administrative penalties.
9. Amends the proposed Order to dismiss all of the claims against Shudak.
10. Makes any further amendments that are necessary to clarify and correct the issues described herein.

DATED this 2nd day of September, 2014.

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1 ORIGINAL and 13 copies of
2 the foregoing hand-delivered on this
2nd day of September, 2014 to:

3 Docket Control
4 Arizona Corporation Commission
4 1200 W. Washington Street
5 Phoenix, AZ 85007

6 COPY of the foregoing mailed
6 on this 2nd day of September, 2014 to:

7 Matthew J. Neubert
8 Arizona Corporation Commission
8 Securities Division
9 1300 West Washington Street, 3rd Floor
9 Phoenix, AZ 85007

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