

STATE OF ARKANSAS
SECURITIES DEPARTMENT

IN THE MATTER OF

MDM ENERGY, INC., MICHAEL L.
RAFAEL, PETE IRBY, GARY
LEEPER and ALL PERSONS
EMPLOYED BY OR OTHERWISE
AFFILIATED WITH THOSE ENTITIES
OR THOSE PERSONS

No S-03-017-03-CD01

CEASE AND DESIST ORDER

The Staff of the Arkansas Securities Department (the Staff) has received information and has in its possession certain evidence which indicates that MDM ENERGY, INC., MICHAEL L. RAFAEL, PETE IRBY and GARY LEEPER have violated provisions of the Arkansas Securities Act (the Act), codified at Ark. Code Ann. §§ 23-42-101, *et seq.* (Repl. 2000).

FINDINGS OF FACT

1. MDM Energy, Inc. (MDM) is a Texas corporation incorporated on 10 September 1981. Its status as a Texas corporation was forfeited for failure to pay franchise taxes on 18 February 1998, but was reinstated on 3 December 2001. For much of its life, MDM was located in Bowling Green, Kentucky. Presently and at all times discussed in this order, its principal office has been located at 1700 Commerce Street, Suite 1500, Dallas, Texas 75201.
2. Michael L. Rafael (Rafael) is the founder of MDM. Listed as the president and director in MDM's incorporation records, he is presently MDM's chief operating officer, board chairman and registered agent for service of process.
3. Pete Irby (Irby) is a vice president of MDM. Irby is not presently registered with the Arkansas Securities Department in any capacity.

4. Gary Leeper (Leeper) is a vice president of MDM. Leeper is not presently registered with the Arkansas Securities Department in any capacity. A search of the records of the Arkansas Securities Department also shows that he has never been registered in any capacity in the securities industry in the United States.
5. On or about 14 April 2003 an unknown representative of MDM telephoned an Arkansas resident (AR) and asked AR if he would be interested in looking at an investment into a working interest in an oil well to be drilled in Illinois. AR stated that he would be interested, and a packet of information was sent to him via overnight delivery. In the packet was a private placement memorandum (PPM), a subscription agreement and various sales materials. The PPM revealed that MDM was offering a fractional working interest of 3.125% representing a 2.34375% net revenue interest in a one well drilling project in Effingham County, Illinois, in the Illinois basin. A map in the PPM showed that the Illinois basin oil field covered parts of the states of Illinois, Indiana and Kentucky. MDM was attempting to raise \$464,000 by selling thirty-two (32) units for \$8,500 each and \$6,000 each in completion costs. MDM would also charge investors \$25 per month per unit as an operating and administrative fee. It was represented in the PPM that the securities offered were exempt from the registration provisions of the federal securities laws and the securities laws of all the American states, no specific exemption was cited anywhere in the packet of printed materials sent to AR. According to the PPM, the offering terminated on 28 February 2003, and there was no provision for extending the offering.

6. The PPM contained other misrepresentations. MDM was listed as the operator, and Rafael was listed as MDM's founder and present CEO and chairman. MDM was said to have been "actively involved in the oil and gas industry since 1981." Rafael was noted as a past president of the Kentucky Independent Petroleum Producers Association and a present member of the Kentucky Oil and Gas Association.
7. On 17 April 2003, Irby telephoned AR to discuss the printed materials AR had received. AR first asked Irby if he had sent the wrong information because the PPM indicated that the offering had expired in February. Irby stated that the offering actually stayed open until all the units were sold. Irby indicated that a provision for extending the offering appeared later in the PPM, but no such provision appears in the PPM or in any other document enclosed with the PPM. Irby was not able to give AR an independent source he could consult to determine if the amount MDM wanted from its investors to drill the proposed well and put it into production was reasonable for the area in which the well was to be located.
8. Irby turned the telephone over to Leeper when AR asked about a way to determine if MDM's stated costs were reasonable. Leeper said that drilling for oil in Illinois became feasible and profitable for two reasons. One was because some unnamed tax laws changed in 1986. The second reason was the development in the last year of what he called "under balanced drilling." In this new way of drilling oil wells, Leeper said, water or another liquid was used instead of drilling mud in order to prevent blowouts and stabilize bottom hole pressure. Leeper said that Rafael had drilled over 200 wells in Illinois, Kentucky

and Indiana and had an 85% success ratio. 120 of these wells were still producing, Leeper said. Leeper said that MDM was originally an Indiana corporation that Rafael had moved to Dallas because he liked the weather better there. In regard to the well that was to be drilled in this project, Leeper said that because it was going to be drilled so closely to a well that was producing an unusually large amount of oil, this well would definitely be a good well: "I can't tell you if it's gonna be a 1,000 barrel or, or a 5,000 barrel, but we're gonna make a well." When AR pointed out that it would be possible to drill a dry hole even next to a producing well, Leeper replied, "No, we're not gonna have a dry hole. . . No, there's no way. . ." Later in the conversation, Leeper said that this well would definitely be successful because Rafael, who had an 85% success ratio, would be at the well while it was being drilled telling the drilling crew what to do. AR noted that according to the PPM these securities had not been registered. Leeper said that working interests in oil wells were never registered because "if they register them they have to say yes we guarantee you're gonna make a well so they don't register them." AR noted that an exemption from registration was asserted in the PPM and asked Leeper what exemption that would be. Leeper replied, "It's a 1942 tax bill thing." Leeper said he knew what the exemption law was when he took his test to obtain a securities license, but could not remember it then. He stated that he had taken the test and had been registered as an agent of an issuer or a broker-dealer in 1989 or 1990.

9. Although it is undisputed that Rafael was in business in Bowling Green, Kentucky for a number of years in the late 1980's and early to mid 1990's, he is not now a member of the Kentucky Oil and Gas Association, as claimed in the PPM and referred to in ¶ 6, above. Although the Staff could not verify that Rafael was a past president of the Kentucky Independent Petroleum Producers Association, also as claimed in the PPM, the Staff did verify that the organization has been defunct since the late 1980's or early 1990's.
10. Irby's statement referred to in ¶ 7, above, that the offering stayed open, regardless of the statement in the PPM that it had closed on 28 February 2003, pursuant to another provision allowing it to stay open until all the units offered were sold was not supported by the PPM. There is no such provision in the PPM or in any other document sent to AR.
11. Leeper's statement referred to in ¶ 8, above, that drilling for oil in Illinois became feasible in part because of the development in the last year of "under balanced drilling," which allowed one to drill using water instead of drilling mud to control bottom hole pressure and prevent blowouts was misleading because 1) under balanced drilling, although relatively new, has been used for at least the last five years, if not longer, and 2) although under balanced drilling does allow the substitution of lighter liquids in the place of drilling mud, it was not the first drilling method to allow the use of water. Indeed, drillers have been able to use water instead of drilling mud for lower pressure wells for decades. Under balanced drilling now usually uses something other than water. See Wilkes, Ted M., *American Oil and Gas Reporter*, Vol. 42, no. 8, pp. 84-87 (August, 1999)(article).

12. Leeper's statements referred to in ¶ 8, above, that there was no way this well could be a dry hole because it was being drilled so closely to a wildly successful well cannot be supported by science or experience. There is simply no assurance that an oil or gas well drilled in close proximity to other wells that are already drilled and producing will also be successful and producing.
13. Leeper's statements referred to in ¶ 8, above, that Rafael had an 85% success ratio and had drilled over 200 wells in Illinois, Indiana and Kentucky, 120 of which were still producing, were demonstrably false. The relevant state agency in Indiana showed that Rafael had never obtained a drilling permit in Indiana and that MDM had never been registered in Indiana as either a domestic corporation, or a foreign corporation. The relevant state agency in Illinois had records showing that the permit for the well to be drilled in this offering was the only permit Rafael or MDM had ever obtained in Illinois. In Kentucky, where MDM was formerly in business, records of the Kentucky Department of Mines and Minerals, Division of Oil and Gas, show that MDM had obtained a total of 69 drilling permits, only 49 of which had been used to drill a well. Of those, 22 were dry holes and only 12 are still producing oil or gas.

14. According to these records of the Kentucky Department of Mines and Minerals, Division of Oil and Gas, at least 14 wells were improperly abandoned, and the state of Kentucky plugged several of them. To obtain a drilling permit in Kentucky, the operator posts a bond to ensure performance of various duties, including plugging the well when it is not producing oil or gas. Because of these violations, MDM's bond was forfeited, and no other drilling permits will be issued to MDM or Rafael in Kentucky. This fact was not disclosed to AR in any of the printed materials sent to AR or by Irby or Leeper.

CONCLUSIONS OF LAW

15. Ark. Code Ann. § 23-42-102(15)(A)(xvi) (Supp. 2001) in pertinent part defines a security as a "certificate of interest or participation in an oil, gas, or mining title or lease".
16. Ark. Code Ann. § 23-42-501 (Repl. 2000) provides that it is unlawful for any person to offer or sell any security which is not registered or which is not exempt from registration under the terms of the Act.
17. Ark. Code Ann. § 23-42-301(a) (Repl. 2000) prohibits as unlawful the transaction of business as an agent by any person who is not registered with the Arkansas Securities Department as such.
18. Ark. Code Ann. § 23-42-102(1)(A) (Supp. 2001) defines agent as, *inter alia*, an individual representing the issuer of securities and effecting or attempting to effect purchases or sales of those securities.

19. Ark. Code Ann. § 23-42-102(9) (Supp. 2001) defines issuer as any person, which is defined in Ark. Code Ann. § 23-42-102(11) (Supp. 2001) to include an individual, corporation, limited liability company or association, who issues or proposes to issue any security.
20. Ark. Code Ann. § 23-42-507(2) (Repl. 2000) provides that it is unlawful for any person in connection with the offer or sale of any security to make any untrue statement or omit to state a material fact necessary in order to make the statements made not misleading in light of the circumstances under which they are made.

OPINION

21. This matter has been properly brought before the Arkansas Securities Commissioner in accordance with Ark. Code Ann. § 23-42-209 (Repl. 2000).
22. The respondents have offered to sell working interests in an oil well without prior registration of those securities in violation of Ark. Code Ann. § 23-42-501 (Repl. 2000).
23. The respondents offered to sell securities in the form of working interests in an oil well without any one of them first being registered with the Department as an agent of the issuer in violation of Ark. Code Ann. § 23-42-301(a) (Repl. 1994).

24. The PPM and the printed sales materials sent to AR making this offer represented that the drilling and completion costs for this well would be \$464,000, but offered no information from an independent source showing that this was a reasonable cost or the current cost of drilling a well of that nature in that locality at this time. Neither Irby, nor Leeper offered any such independent information when speaking to AR on the 17 April 2003. The failure to include such information was the omission of material facts in violation of Ark. Code Ann. § 23-42-507(2) (Repl. 2000).
25. The representation referred to in ¶¶ 6 and 9, above, that Rafael was a present member of the Kentucky Oil and Gas Association was false because Rafael is not presently a member. The representation referred to in ¶¶ 6 and 9, above, that Rafael was a past president of the Kentucky Independent Petroleum Producers Association (KIPPA), without also containing the information that KIPPA had been defunct for about a decade was misleading in that it implied that Rafael still had a presence in the oil and gas industry in Kentucky. Taken together, these representations constituted a violation of Ark. Code Ann. § 23-42-507(2) (Repl. 2000) in that they were both a misrepresentation of fact and the omission of material facts necessary to make the statement not misleading.
26. Irby's statement to AR referred to in ¶ 7, above, that the PPM or some other document in AR's possession authorized the offering to stay open until all 32 units were sold was a misrepresentation of fact in violation of Ark. Code Ann. § 23-42-507(2) (Repl. 2000).

27. Leeper's statement referred to in ¶¶ 8 and 11, above, that drilling for oil in Illinois had become feasible and profitable because of the development in the last year of under balanced drilling was a misrepresentation of fact in violation of Ark. Code Ann. § 23-42-507(2) (Repl. 2000).
28. Leeper's statement referred to in ¶¶ 8 and 12, above, that there was no way that the well to be drilled could be a dry hole was a misrepresentation of fact in violation of Ark. Code Ann. § 23-42-507(2) (Repl. 2000).
29. Leeper's statement referred to in ¶ 8, above, that this offering was exempt from the registration provisions of the federal securities law and the Act because of a "1942 tax bill thing" was a misrepresentation of fact in violation of Ark. Code Ann. § 23-42-507(2) (Repl. 2000).
30. Leeper's statement referred to in ¶ 8, above, that he had been registered as an agent of a broker-dealer or an issuer and had sold securities pursuant to this registration in 1989 or 1990 was a misrepresentation of fact in violation of Ark. Code Ann. § 23-42-507(2) (Repl. 2000).
31. Leeper's statement referred to in ¶¶ 8 and 13, above, that Rafael had drilled over 200 wells in Illinois, Indiana and Kentucky, 120 of which were still producing and that he had an 85% success ratio was demonstrably false and a misrepresentation of fact in violation of Ark. Code Ann. § 23-42-507(2) (Repl. 2000).
32. The failure to disclose to AR that MDM's bond had been forfeited and no other permits would be issued to MDM or Rafael in Kentucky was the omission of material facts necessary to make the statement not misleading in violation of Ark. Code Ann. § 23-42-507(2) (Repl. 2000).

ORDER

IT IS THEREFORE ORDERED that MDM ENERGY, INC., MICHAEL L. RAFAEL, PETE IRBY and GARY LEEPER as well as others whose identities are not yet known who are in positions of control of MDM ENERGY, INC. and who are employed by or otherwise affiliated with MDM ENERGY, INC., directly or through other companies, **CEASE AND DESIST** from any further actions in the state of Arkansas in connection with the offer or sale of the securities described above or any other securities.

WITNESS MY HAND AND SEAL this 12th day of May, 2003.

A handwritten signature in black ink, appearing to read "M. Johnson". The signature is written in a cursive, flowing style.

MICHAEL B. JOHNSON
ARKANSAS SECURITIES COMMISSIONER