



SECURITIES LAW:

The Risks of Raising Funds and Selling Interests in the Oil & Gas Industry

By: James (J.V.) F. Anderton, V and
Michael G. Stefanko
of
Loomis, Ewert, Parsley,
Davis & Gotting, P.C.

09/18/2013

What this presentation is (and is not)

- The goal of this presentation is to help you identify some key issues associated with selling ownership interests in assets/entities.
- This presentation is not intended as legal advice for any specific situation. You are encouraged to seek counsel to discuss any situation you may encounter which raises issues under securities laws.

Food Coma

- Let's be honest. Lunch ended about an hour ago, and it is unlikely most of you deal with securities laws on a daily basis.
- As you will see, when you deal with securities laws you must be careful, because the penalties for failure to comply are severe.
- Stay awake – you might learn something. Besides, there is a break after us.

What are the Basic “Securities Laws?”

- Two broad categories:
 - Federal Laws:
 - Securities Act of 1933 (the “33 Act”)
 - Securities Exchange Act of 1934 (the “34 Act”)
 - Other rules from the Securities and Exchange Commission (“S.E.C.”)
 - State Laws:
 - Commonly known as “Blue Sky Laws” and vary by state
 - Generally, you must comply with both or have an exemption from state laws.

Federal Securities Laws

- Our focus will be on 33 Act issues.
- 34 Act sets forth rules for companies that have on-going reporting obligations due to either the number of owners or because it is “listed” on a stock exchange.

Federal Securities Laws: 33 Act

- So what is a “security?” - Any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, **investment contract**, voting-trust certificate, certificate of deposit for a security, **fractional undivided interest in oil, gas, or other mineral rights**, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security”, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing. 15 USC 77b.

Federal Securities Laws: 33 Act (Cont.)

- What is an “investment contract?”
 - According to the Supreme Court it is “a contract, transaction or scheme whereby a person (1) invests his money (2) in a common enterprise and (3) is led to expect profits (4) solely from the efforts of the promoter or a third party.” This is the “Howey Test.”

Federal Securities Laws: 33 Act (Cont.)

- While all four factors of the “Howey Test” must be satisfied for an “investment contract” to be determined to be a security, the focus of any dispute will likely revolve around the last two factors – that the Investors are led to expect profits solely from the efforts of others.
- Further, the factual distinctions between the cases where the interests sold were determined to be securities and where the interests sold were determined not to be securities can seem insignificant.

Federal Securities Laws: 33 Act (Cont.)

- Investments found to be securities in the oil & gas industry:
 - The sale of a fractional interest in an oil and gas lease was a security when the managerial decisions that would dictate success or failure remained with the seller. *Parvin v Davis Oil Co.*, 524 F.2d 112 (9th Cir. 1975).
 - If a fractional undivided interest is created for purposes of a sale, the conveyance of the interest is the sale of a security. *Nolfi v Ohio Kentucky Oil Corp.*, 675 F.3d 538 (6th Cir. 2012).
 - **This case is from the Sixth Circuit and is the controlling law in Michigan. As you will see below, certain jurisdictions differ slightly, but they appear to get to the same result.**
 - If an investment is a fractional undivided interest in oil or gas, then the statute specifies that it is a security as a matter of law. *Id.*

Federal Securities Laws: 33 Act (Cont.)

- Investments found not to be securities in the oil & gas industry:
 - Not every sale of a fractional interest in oil, gas, or other mineral rights is the sale of a security. *Woodward v Wright*, 266 F.2d 108 (10th Cir. 1959).
 - This position seems contrary to the Sixth Circuit's ruling. The distinction is that while an interest is a security, participation in the activities of the entity may remove the matter from the registration requirements.
 - It does not include isolated sales or assignments of oil and gas leases or fractional parts thereof to specific person (ultimately this case held the interest was a security). *Id.*
 - The sale of a fractional interest to an entity involved in the oil and gas industry and had control over the wells at issue was not a security. *Ballard & Cordell Corp. v Zoller and Danneberg Exploration, Ltd.*, 544 F.2d 1059 (10th Cir. 1976).

Federal Securities Laws: 33 Act (Cont.)

- Investments found not to be securities in the oil & gas industry (continued):
 - Entering into an oil and gas lease with a landowner is not a security. *Fearneyhough v McElvain*, 598 F.Supp. 905 (C.D. Ill. 1984).
 - The transfer of all of one's interest in an oil and gas lease is not a security. *Graham v Clark*, 332 F.2d 155 (6th Cir. 1964)

Federal Securities Laws: 33 Act (Cont.)

- These issues do have the attention of the S.E.C.
 - In May of 2013, the S.E.C. issued an Investor Alert on Private Oil and Gas Offerings.
 - This was only 1 of 6 Investor Alerts issued by the S.E.C. thus far in 2013. These Investor Alerts focus primarily on potentially fraudulent activities.

Federal Securities Laws: 33 Act (Cont.)

- So you think you have a security?
 - See a lawyer to help with either (1) registration or (2) find an applicable exemption.
 - Registration: Unless an exemption applies, securities that are being offered must be registered with the S.E.C. and frequently the applicable state.
 - Registration is time consuming and costly.

Federal Securities Laws: 33 Act (Cont.)

- If you want to avoid registration, you must be able to fit within an exemption.
 - There are exempt securities and exempt transactions. Generally, exempt securities will not be applicable to oil & gas situations, so the key is finding an exempt transaction.
 - Exempt transactions include (1) intra-state offerings, (2) private offerings, and (3) small issue offerings.

Federal Securities Laws: 33 Act (Cont.)

- Exempt transactions sound interesting? You are in luck! This presentation is meant to be an introduction into securities laws, with a later presentation to focus in detail on exempt transactions and their requirements.

Federal Securities Laws: 33 Act (Cont.)

- Are there other aspects to the 33 Act beyond registration or exemption?
 - Yes. The 33 Act has rules regarding how sales by the issuer/promoter must occur, how “downstream” sales must occur.
 - The 33 Act also provides for enforcement by any person who purchases a security that was sold without complying with the 33 Act.

Federal Securities Laws: 33 Act (Cont.)

- How does enforcement work?
 - Any security that is not sold in compliance with the 33 Act registration requirement or an applicable exemption therefrom, can be subject to a suit. Note: there is no requirement that something went wrong, it is enough that the security was sold without compliance with the 33 Act.

Federal Securities Laws: 33 Act (Cont.)

- What are the damages?
 - Either (1) rescission (plaintiff returns the security and defendant returns the payment with interest) or (2) the loss on plaintiff's investment if plaintiff has sold the security.
- Who is liable?
 - The “seller.” However, courts have included in the definition anyone who was an active participant in negotiation of the sale in question.

Federal Securities Laws: 33 Act (Cont.)

- How long after the purchase does a plaintiff have to bring a suit?
 - Generally the statute of limitations is 1 year, but it can be up to 3 years in the case of fraud.
 - Takeaway for you: if you are selling a security and plan to do something with the money raised, either comply with the 33 Act or risk a rescission suit long after the money has been used.

Federal Securities Laws: 33 Act (Cont.)

- More enforcement issues:
 - In addition to purchasers of securities having enforcement rights, the S.E.C. can investigate and enforce the securities laws. Remedies available to the S.E.C. include (1) civil fines, (2) cease and desist orders, and (3) other injunctive orders to prevent future violations of the laws.

Federal Securities Laws: 33 Act (Cont.)

- The really scary enforcement issue:
 - The justice department can seek criminal charges in cases of willful misrepresentation and fraud. The punishment if found guilty is prison.

Federal Securities Laws: 34 Act

- Rule 10b-5 (promulgated under the 34 Act) is applicable to securities exempt from registration under the 33 Act and 34 Act, and allows a person to file a suit for fraud.
- Limitations period is 2 years after discovery or 5 years after the transaction occurred.

Blue Sky Laws

- Laws generally cover registration (and exemptions) of securities, and distributions of securities by brokers/dealers.
- Remedies of a purchaser of a security under the Michigan Uniform Securities Act of 2002 are similar to the remedy under the 33 Act, but the Michigan Act explicitly contemplates the plaintiff can also have their attorney fees paid.

Blue Sky Laws (Cont.)

- Note that for registration/exemptions under state laws, Congress enacted laws in the 1990s that “pre-empted” various state laws regarding registration. However, it is important to have an attorney determine if the registration process or applicable exemption therefrom at the federal level pre-empts any blue sky requirements.

Blue Sky Laws (Cont.)

- There have been recent examples in Michigan of individuals/companies violating securities laws – see, e.g., *Jordan River Resources*
 - Between 2003 and 2007, a group of individuals solicited funds from investors in the mid-Michigan area.
 - The company promised 6.0% returns per month from oil and gas exploration activities in Oklahoma and Texas.
 - This case was not a simple matter of failing to register. This was essentially a Ponzi scheme and the guilty parties were charged criminally.
 - While failing to comply with securities requirements does not require fraud, companies that fail to comply and face lawsuits and enforcement will likely be viewed in the same light. This would make finding future investors much more difficult.

The JOBS Act & Crowdfunding

- What is all the fuss about?
 - Jumpstart our Business Startups Act of 2012 was supposed to allow for the “little guy” to invest in non-publicly traded companies with fewer legal hurdles.
 - What you need to know, is that to this point the S.E.C. has not provided full regulatory guidance for how this will work.

Questions?

- Thank you for your time.
- Please feel free to contact either:
 J.V. Anderton, Esq. - jfanderton@loomislaw.com
 or
 Michael G. Stefanko, Esq. – mgstefanko@loomislaw.com

124 W. Allegan, Suite 700
Lansing, MI 48933
(517) 482-2400