Oil and Gas and Securities Law:
A Wake Up Call for Alabama Oil and Gas Companies

February 7, 2014

Thomas L. Krebs and Randy McNeill[1]

Alabama produced nearly 10,000 barrels of crude oil last year – an increase of more than a third since 2010, reversing a two year decline in production.[2] This increase in oil production will result in new jobs and could have a substantial economic impact on the state. This heightened activity will likely be accompanied by developer/operators seeking and soliciting investors for the drilling of wells. However, the solicitation of these investments will require compliance with the securities laws.

Sales of oil and gas working interests are sales of a"security" under the securities laws of the state of Alabama.[3] The disclosure requirements of the Alabama Securities Act (herein after the "ASA") apply to sales of working interests the same as it would in the sale of shares of common stock or shares of a mutual fund company. All such securities are required to be registered prior to sale.[4] The failure to register securities prior to sale in Alabama, including fractional

---

[1] Mr Krebs is a former Director of the Alabama Securities Commission, founder of Thomas L. Krebs, LLC and a securities attorney in Birmingham, Ala. Mr McNeill is the former Deputy Director of the Alabama Securities Commission. He is currently a partner in the Montgomery. Alabama law firm of Webb and Eley, LLC.

[2] J. Pepper Bryars, "DRILL, BAMA, DRILL: Our state is a player in the U.S. oil and gas boom." August 05,2013, http//al.com/opinion/index.ssf/2013/08/drill_bama_drill-our_state_is.html. *See also* Institute for Energy Research (http//www.institutefor energyresearch.org/2013/03/25/want-affordable-energy-ask-alabama/)

[3] Ala. Code Section 8-6-2 (10) (1943) defines a security, in part, as a "... certificate of interest or participation in an oil, gas, or mining title or lease or in payments out of production under such a title or lease," *See also*, *Upton v. Trinidad Petroleum Corporation*, 468 F. Supp. 330 (N.D. Ala. 1979), *aff'd on other grounds*, 652 F.2d 424 (5th Cir. 1981) ("The gas well interests which are the subject of the suit are securities under both federal and Alabama law."); *See also*, *Pinter v. Dahl,* 486 U.S. 622,108 S .Ct. 2063, 100 L. Ed. 2d 658 (1988) and *Adena Exploration, Inc. v. Sylvan* 860 F. 2d 1242 (5th Cir. 1988) ("If a fractional undivided interest is created for the purpose of sale, the conveyance of the interest is the sale of the security.") citing *Woodward v Wright*, 266 F.2d 108 (10th Cir. 1959)

[4] Ala. Code Section 8-6-4 (1975), Registration of securities – required; exceptions. "It is unlawful for any person to offer or sell any security in this state unless: (1) it is registered under this article; (2) the Security is exempt from registration under Section 8-6-10; or (3) the transaction is exempt under Section 8-6-11.

undivided working interests, is a class C felony.[5] Further, in addition to the criminal fraud penalties,[6] any person who: "(a) sells or offers to sell a security in violation of any provision of the ASA, or (b) sells or offers to sell a security by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading… is liable to the person buying the security from him who may bring an action to recover the consideration paid for the security, together with interest at 6% per year from the date of payment, court costs and reasonable attorneys fees, less the amount of any income received on the security… or for damages if he no longer owns the security."[7] Thus, the developer/operator that sold the working interest and every person who directly or indirectly controls the developer/operator liable under Sections 8-6-19 (a) and (b), including every partner officer or director or employee who materially aids in the sale, are also liable jointly and severally to the same extent as the person liable under subsections (a) or (b). [8]

It is unfortunately commonplace for many participants in Alabama's oil and gas industry, particularly in the sale of interests in oil and gas to ignore the requirements of federal and state securities laws applicable to these activities; they often do not register or qualify their offerings with federal and state authorities, comply with the requirements for claiming a securities registration exemption, or make "full disclosure" to prospective investors.

[5] Ala. Code Section 8-6-18 (1975) provides as follows: "Criminal penalties for violations of article; enforcement; scienter. (a) A person who willfully violates Section 8-6-3 or Section 8-6-4, upon conviction, shall be guilty of a class C felony…(e) in any proceeding under this article, scienter need not be alleged and proved in prosecutions involving the sale of unregistered securities or in the failure to register as a dealer, agent, investment advisor or investment advisor representative under this article.

[6] Ala. Code Section 8-6-18 (a) (1975) provides:"A person that willfully violates subsection (a), (b), or (c) of Section 8-6-17, upon conviction, shall be guilty of a Class B felony. No prosecution may be commenced under this article more than five years after the alleged violation."

[7] Ala. Code Sections 8-6-19 (a) and (b) (1975).

[8] Ala. Code Section 8-6-2 (24) (1975) defines a control as follows: "… the possession, directly or indirectly, or the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract or otherwise."

Working interests in oil and gas leases are "securities" under the Securities Act of 1933 ("the Securities Act of 1933"), the Securities Exchange Act of 1934 ("the 34 Act") and the ASA because (1) working interests are "fractional undivided interests in oil, gas or other mineral rights" or "interests in or under oil, gas leases" and (2) working interests coupled with an operating agreement and promotional scheme are "investment contracts" under the provisions of all three of these laws.[9] A non-operating working interest owner in oil and gas lease is an undivided co-owner and tenant in common with the other working interest owners and by definition, such a person owns (1) a "fractional undivided interest in oil, gas or and mineral rights" under the Securities Act of 1933, (2) a "…participation in any oil, gas or other mineral royalty or lease" under the 34 Act and (3) an "interest in or under oil, gas or mining leases" under the ASC.[10] It should go without saying that a participation in an oil and gas lease in the form of a limited partnership interest or of a non-managing general partnership interest, or non-managing membership interest in a limited liability company is also a security.

There are four consequences that flow from the fact that working interests are securities:

1. unless an exemption from registration is available, the sale of the working interests is required to be registered under the registration requirements of the securities Act of 1933 and the ASA;

[9] *Upton v. Trinidad Petroleum Corp.,* 468 F. Supp. 330, 334 (N.D. Ala. 1979), *aff'd on others grounds,* 652 F. 2d 424 (5th Cir. 1981) ("The gas well interests which are the subject of the suit are securities under both federal and Alabama law.") *See also* Pinter v. Dahl,486 US 622, 100 L. Ed. 2d 658 (1988); *Adena Exploration, Inc. v. Sylvan* 860 F. 2d 1242 (5th Cir. 1988) ("If a fractional undivided interest is created for the purpose of sale, the conveyance of the interest is the sale of the security.") citing *Woodward v Wright*, 266 F.2d 108 (10th Cir. 1959) ("[a] fractional undivided interest in oil and gas becomes a "security" when it is created out of the ownership of an interest in oil and gas, and this is so even though what he sold was a fractional interest therein or other mineral rights for the purpose of sale or offering for sale.")

[10] *Upton v. Trinidad Petroleum Corp.* 468 F. Supp. 330 (N.D. Ala. 1979) *aff'd on other grounds*,652 F.2d 424 (5th Cir. 1981).

2. notwithstanding the fact that the sale qualifies for an exemption, disclosure of all material facts relating to the investment must be made to the purchasers;
3. unless the transactions qualify for the Section 8-6-11 (a)(9) small offering exemption listed below a person who effects the sale of a security on behalf of the issuer may have to be licensed as a broker-dealer; and
4. a sale of securities that does not comply with the requirements of the ASA and federal securities laws, exposes participants to both civil and criminal enforcement actions

In Alabama there exists a self executing exemption from the registration requirement of Section 8-6-4. That exemption is found in Section 8-6-11 (a)(9), and provides as follows:

> Any transaction which is a part of an issue of which there are no more than 10 purchasers, wherever located, of securities from the issuer during any period of 12 consecutive months if:
>
> (a) The issuer reasonably believes that all the buyers are purchasing for investment and not with a view to distribution, and such issuer exercises reasonable care to assure this investment intent, which reasonable care shall be presumed; provided that the following conditions are satisfied:
>
> 1. Reasonable inquiry to determine if the purchaser is acquiring the securities for himself or herself or for other persons;
> 2. Written disclosure to each purchaser prior to sale that the securities have not been registered under the act and, therefore, cannot be resold unless they are registered under the act or unless an exemption from registration is available;
> 3. placement of a legend on the certificate or other document that evidences the securities, stating that the securities

have not been registered under the act and setting forth or referring to the restrictions on transferability and the sale of securities; and

(b) No commission or other remuneration is paid or given directly or indirectly for soliciting any prospective buyer; and

(c) No public advertising or general solicitation is used in connection with the issue of which the transaction in reliance on this exemption is a part.[11]

While no filing with the Commission is required under the Section 8-6-11 (a)(9) exemption if challenged by an investor in court or by the Commission, a developer/operator must prove that all conditions of the exemption have been met. The Section 8-6-11 (a)(9) exemption is not the only way to avoid an the registration requirements of the ASA because the Commission may by rule, or order, as to any type of security or transaction, withdraw or further condition this exemption or decrease or increase the number of purchasers permitted.[12] However, in those instances where securities are sold pursuant to a statutory exemption or an exemption from registration under a Commission rule, the burden of proving the availability of that exemption remains upon the person claiming it.[13] Although the 8-6-11 (a)(9) exemption is self executing - that is, no filing is required to be made with the Commission before sales are made - given the consequences of a failure to perfect a claim to the exemption, extraordinary care must be taken to comply with the fundamental conditions of a valid claim of the exemption, such as the number of purchasers limitation and the prohibition against the payment of any commission or other remuneration.

The Commission has also issued regulations relating to other exemptions which are, for the most part, tied to federal exemptions from full registration of securities. Perhaps the most important of these is the SEC's Regulation D exemption[14] and Rule 506 of Reg. D.[15] In 1996 Congress passed the National

---

[11] Ala. Code Section 8-6-11(a)(9) (1975).

[12] Ala. Code Section 8-6-23 (1975).

[13] Ala. Code Section 8-6-30 (1975) mandates: "In any proceeding under this article, the burden of proving an exemption or exclusion from a definition is on the person claiming it. "

[14] 17 C.F.R. Sections 230.501–230.506.

Securities Markets Improvement Act (NSMIA) which preempted state securities regulators from imposing registration or qualification requirements on the offer or sale of NSMIA "covered securities." As a result of NSMIA, Rule 506 of Reg. D securities are not subject to any state regulator's pre-issuance registration oversight, but the states retained jurisdiction in cases of fraud and yet retained some oversight of the broker-dealers who offer and sell securities pursuant to Rule 506 offerings. For example, anyone who attempts to sell Rule 506 offerings and is paid a commission for such sales in Alabama must be licensed by the Alabama Securities Commission. Additionally, as will be seen in the following pages, the Rule 506 exemption must actually exist before NSMIA preemption is effective.[16]

The Alabama small offering exemption itself has by rule been modified to permit flexibility in small offerings. However, those changes to the Alabama rules did little to liberalize the statutory small offering exemption. The number of permissible purchasers was increased from 10 to 25, but the rule requires a filing be made with the Securities Commission to perfect the expanded exemption and the prohibition against the payment of securities sales commissions remains intact, except where commissions are paid to licensed broker-dealers.

Claims to the applicability of the statutory exemption from registration found in Section 8-6-11 (a)(9) in connection with sales of fractional undivided working interests in oil and gas leases are, given the consequences of a failure to neet every condition mandated by the exemption, fraught with peril and should not be made absent advice from an experienced securities attorney. The issues to

---

[15] 17 C.F.R. Section 230.506. SEC Rule 506 was adopted under Section 4 (2) of the securities act of 1933 - the federal "private offering" exemption. It was not a new exemption but rather a safe harbor to ensure the validity of the exemption when proceeding independently under Section 4 (2). As a safe harbor, Rule 506 and all of Regulation D mandate specific compliance requirements. Although Regulation D allows for an insignificant deviation from its requirements, a material failure to comply invalidates the exemption. Congress believe that including rule 506 offering as a category of NSMIA's "covered securities" eliminated many blue sky hurtles to capital formation activities. *See also*, *Brown v. Earthbound Sports Usa,* 481 F3rd 901, 905 6th Cir. (stating that "Rule 506 permits a private issuer to sell unregistered securities to any "accredited investor" and up to 35 unaccredited purchasers so long as certain requirements are met.")

[16] See pps. 32-34.

be confronted relate, among other problems, to the following: (1). What is a commission or other remuneration? (2). What is a single investor for purposes of the 10 or fewer purchaser limitation in Section 8-6-11 (a)(9)? (3). What limitations can be placed on the resale of undivided working interests? (4). When does the sale take place? and (5). What disclosures should be made to prospective working interest owners?

1. **What is a commission or other remuneration for the solicitation of prospective investors?**

If the developer/operator receives some form of compensation, disclosed or undisclosed, (whether it be an amount charged investors in excess of the actual cost of a turnkey drilling contract, or a carried interest or a mark-up in the price of the underlying mineral leases) there is a risk that the difference between the actual cost of the contract to drill the well / the carried interest/ the price paid to acquire the mineral leases and the amount charged investors will be considered as securities sales commissions. The effect of such a finding may subject the developer/operator to state or federal regulatory sanction, including criminal prosecution,[17] civil liability or fines, plus disgorgement of profits and rescission[18] to the investors in almost strict liability failure to register securities civil actions. Once the availability of the exemption is disproved these cases become rather simple; it is much like driving 65 miles an hour in a 35 mile per hour zone; you did it, you pay.

In *Upton v. Trinidad Petroleum Corporation,*[19] the Fifth Circuit agreed that Trinidad**,** should have registered the working interests sold investors with the Alabama Securities Commission because Trinidad was the recipient of prohibited compensation. The disqualifying compensation received by Trinidad was in the nature of the funds it collected from the investors which greatly exceeded the actual cost attributable to the turnkey drilling price negotiated by Trinidad for the

[17]Ala. Code Section 8 -6-18 (e) (1975) provides: "In any proceeding under this article, scienter need not be alleged and proved in prosecutions involving the sale of unregistered securities or in the failure to register as a dealer, agent, investment adviser, or investment adviser representative under this article."
[18] Under the ASA, a recovery for unregistered sales of securities will equal the return of investor funds, plus 6% from the date of investment, court costs and attorneys fees. See Ala. Code Section 8-6-19 (1975).
[19] 468 F. Supp 330 (N.D. Ala.1976), *aff'd on other grounds* 652 F 2d 424 (5^{th} Cir. 1981).

drilling of the well. The Court noted "… [t]he money collected in excess of the cost of the turnkey drilling contract constituted indirect remuneration under [Section 8-6-11 (a) (9)]."[20] Plaintiff had also alleged that because the developer/operator received a $3,000 profit through the markup of the leasehold interest sold to investors Trinidad actually received two forms of indirect compensation for the solicitation of investors, but the court did not rule on this aspect of the plaintiff's claims.[21]

The fact that these excess funds, or claimed "profits," were not disclosed to investors was certainly a factor considered by the court in rendering the decision; investors were expressly promised that their contributions would be used for drilling costs only.[22] The court reasoned that the money retained by Trinidad in excess of the actual drilling costs was not a profit in the ordinary sense in that it was not derived from the operation of the business.[23] Rather it flowed directly from the investors to Trinidad as a consequence of [the developer/operator's] efforts to solicit purchasers of the interests in the Well Number 2."[24] The court went on to explain that Trinidad's claim to need a reserve for contingencies, such as increases in prices, blowouts, fires and other disasters was: (1). never disclosed to investors; (2). bore no relation to the actual risks claimed to be involved; and, (3). even if legitimately created there should have been some mechanism for returning the excess to the investors on a pro rata basis when the contemplated contingencies did not materialize.[25]

The funds received by Trinidad were to be paid even though the well could have turned out to be a dry hole.[26] The compensation paid Trinidad came directly from the investors and payment to it was not conditioned upon drilling results.[27]

---

[20] 468 F. Supp. at 336-337.
[21] *Id*. Neither did the Fifth Circuit touch upon whether the mark up in the leases constituted a commission or other remuneration prohibited by Section 8-6-11 (a)(9). 652 F.2d 426-427.
[22] *Id.*
[23] *Id.*
[24] *Upton v. Trinidad Petroleum Corp*. 652 F 2d 426.
[25] *Id*. at 427.
[26] Id. at426 ("It [the funds collected from the investors **which greatly exceeded the actual drilling costs**] flowed directly from the investors to Trinidad as a consequence of Beard's efforts to solicit purchasers of interests in Well No. 2.")(emphasis added)
[27] *Id.*

Trinidad was to have been paid the difference between the actual costs of the turnkey drilling agreement which was an amount much less than the amounts paid by investors for drilling.[28] Trinidad first negotiated a turnkey drilling amount then solicited investors. No matter how the well fared, Trinidad would have made money. In this case, but for the solicitation of investors, Trinidad would not have made any money.

The facts in the Trinidad case should be distinguished from a carried interest for the reason that with a carried interest, if the developer/operator makes money it is because the well is successful and the developer/operator is rewarded out of production payments. The funds paid a developer/operator do not flow directly from the investors to the developer/operator, but are derived from the operation of the business, i.e., the discovery of a producing well and from production from that well. The developer/operator's financial interests are tied to those of the working interest owner/investors. They all want a producing well. If it's a dry hole, the developer/operator gets nothing, whereas Trinidad won (made money) even though its investors lost.

The fact that the existence of the receipt of these funds by Trinidad was not disclosed to the prospect of investors was surely a factor considered by the court in reaching its determination about whether these additional funds constituted the receipt of "a commission or other remuneration,… directly or indirectly, for the solicitation of a prospective buyer",[29] but it is probable that the result would have been the same had disclosures of the excess compensation been made to the investors.

This precise question was answered in *Petroleum Resource Development Corporation v. State*.[30] There the Administrator of the Oklahoma Securities Commission informed Petroleum Resource Development Corporation (the issuer) that the payment of sales commissions without registration of working interest securities was a violation of the Oklahoma Securities Act. When notified of this requirement, the issuer discontinued payment of sales commissions and agreed

[28] Id. at 426-427.
[29] Ala. Code Section 8-6-11(a)(9) (1975).
[30] 585 P2d 348 (Okla. Sup. Ct. 1978)

to amend its offering documents in an attempt to comply with the directives of the Administrator. In its amended sales document the issuer stated "If all units offered hereby are purchased, a total of $63,404.22 will be available. It is estimated that drilling and testing costs will total $28,280.00. The balance of the investors' funds paid for drilling and testing will be utilized to meet any unexpected contingencies encountered in drilling. Any surplus remaining will be retained by the [developer/operator] as a payment for leasehold selection and acquisition and drilling supervision."[31] Further, the developer/operator disclosed that it would retain 23.5% of the working interest, although not obligated to contribute any capital to the venture unless drilling and completion costs would exceed the amount received from the investors.[32] The amended offering documents also disclosed that the issuer agreed to drill, and if appropriate, complete and equip the well for the amount represented by the proceeds from the sale of the working interests to the investors. The amounts required to be expended in excess of the amount charged investors would be the issuer's obligation, but the issuer would be free to retain any amounts not required for drilling purposes with no duty to account to the investors. The working interests were to be sold to investors by the officers and directors of the issuer, as no sales force would be employed and no commissions would be paid the officers and directors in connection with the solicitation of prospective working interest purchasers. The Oklahoma Securities Commission Administrator found that the investors' proceeds retained by the issuer in excess of the direct and indirect costs associated with the exploration project were, in fact, a form of "indirect remuneration for the solicitation of sales" within the meaning of the Oklahoma small offering exemption's prohibition against the payment of commissions.[33]

---

[31] *Petroleum Resource Development Corporation v. State*, 585 P. 2d 346, 348-349 (Okla.1978); *see also*, *Upton v. Trinidad Petroleum Corp.* 652 F.2d at 425-426.

[32] This appears to be something in the nature of a carried interest.

[33] *Petroleum Resource Development Corporation v. State*, 585 P 2d 346, 348 (Okla 1978). Further, Like Ala. Code Section 8-6-11 (a)(9) (1975), the Oklahoma small offering exemption also prohibits the payment of commissions directly or indirectly for the solicitation of any prospective buyer. Oklahoma and Alabama are both Uniform Securities Act states and interpretation of the same language under another Uniform Act jurisdiction is also persuasive for purposes of interpreting Alabama's Uniform Act language.

The issuer appealed the finding of the Oklahoma Securities Commission claiming that its agreement not to pay salespersons a commission placed his company in compliance with the Oklahoma Securities Act's small offering exemption. The Securities Commission countered by saying that under the economic realities test (which states that the economic realities of a transaction should control, not the form of the transaction) this amended additional compensation in the form of "drilling supervisory fees" constituted a form of indirect remuneration. The Oklahoma Supreme Court agreed.

This result was much like the *Trinidad Petroleum* case in that the costs of drilling and testing were substantially less than the prices for drilling and testing charged the working interest owner/investors and the excess was to be paid to the developer/operator directly by the investors. Again, like Trinidad**,** the developer/operator's interests were not tied to those of the investors and Petroleum Resource Development Corporation was assured of making money even when the investors lost money in drilling the well when it proved to be a dry hole.

It should be clear that the disclosure or non-disclosure of the existence of excess payments by working interest owners and the retention of those excess payments by the developer/operator (outside of a securities fraud context) may not be a factor in determining whether the excess working interest owners' payments retained by the developer/operator are a commission or other form of remuneration for purposes of establishing a valid claim to the 8-6-11 (a)(9) small offering exemption. These funds flow directly from the investor to the developer/operator and are to be received by the developer/operator even if the drilling venture is a failure. The receipt of such compensation by itself, whether disclosed or not, would constitute "other remuneration" so as to defeat the availability of the small offering exemption.

Carried Interests as Securities Sales Commissions.

While the Oklahoma Supreme Court in the *Petroleum Resource Development Corporation* case may have sidestepped the question of whether a carried interest[34] in an oil and gas well was a commission or other form of remuneration for purposes of interpreting Oklahoma's small offering exemption, other courts have not been as reluctant to address the question. In *Prince v. Heritage Oil Company*[35] the defendants sold the plaintiffs fractional interests in oil and gas leases. The defendants also retained interests in the same leases. The capital contribution of the outside investors for their leasehold interest, when compared to the capital investment of the developer/operator for his leasehold interest, equaled a 5 to 1 ratio.[36] The plaintiffs purchased interests in three wells: in the first well there were 11 investors who purchased in the aggregate a 18/64 leasehold working interests in 6/8 of the well for a total of $63,900.00; in the second well there were 13 investors who purchased a 23/64 leasehold working interest in 6/8 of the oil and gas for a total of $82,800.00, and there were five investors in the third well who purchased a 9/64 leasehold working interest in 6/8 of the oil and gas for total of $32,400.00.[37] The defendants' total itemized costs for the first well was $64,486.40; the total itemized cost for the second well was $53,384.55; and the total itemized costs for the third well was $72,031.56.[38] The first and third wells were deemed by the lower court to be entitled to the small offering exemption since neither the leasehold working interests retained by the defendants nor the reimbursement for expenses constituted commissions or direct or indirect remuneration for soliciting the sales. But the lower court did find that the second well did not fall within the exemption because defendants received remuneration of $29,415.45 - the difference between the amount

[34] A carried interest is a fractional interest in an oil and gas property, usually a lease, the holder of which has no personal obligation for operating costs, which are to be paid by the owner or owners of the remaining fraction, who reimbursed themselves out of production, if any. The person advancing the costs is the carrying party and the other the carried party. 8 Williams and Meyers, *Oil and Gas, Law Manual of Terms*, 102 (1984). *See also*, *Mayfield v, H.B. Oil and Gas,* 745 P. 2d 732, 733 (Okla. 1987) ("a carried interest is a fractional interest in an oil and gas property, usually a lease, the holder of which has no personal obligation for operating costs, which are paid by the owner or owners of the remaining fraction, who reimburse themselves out of production, if any. The person advancing the costs is the carrying party and the other is the carried party.")
[35] 109 Mich. App 189, 311 N. W. 2d 741 (1981)
[36] *Id*. at 201
[37] *Id.* at 194.
[38] *Id.*

investors contributed and the actual costs to drill the well - and awarded plaintiffs their funds for the second well, plus interest.

The Court of Appeals overturned the lower court after noting "[t]hat the availability of the exemption hinges on whether defendants retention of leasehold working interests in the oil and gas wells constituted the receipt of 'a commission or other remuneration'… paid or given directly or indirectly for soliciting any prospective buyer."[39] In the first well the defendants had retained a 46/64 leasehold working interest of 3/4 of all oil and gas by contributing only $584.40 to the cost of drilling as compared to the $63,900 contributed by the investors.[40] In the second well, the defendants received a 41/64 leasehold working interest of 3/4 of all oil and gas without any financial expenditure from their own pockets.[41] In the third well, defendants retained a 55/64 working interest of 3/4 of all oil and gas for investment of $39,631.56, while the other investors that contributed $32,400 for only a 9/64 leasehold working interest.[42]

In each well the defendants paid much less per share than the outside investors. The Michigan Court of Appeals held that "… the receipt of securities by promoters **for prices grossly below those paid by outside investors amounts to other remuneration.**"[43] The court also explained that the effect of the interests retained by the defendants was to dilute the equity paid by outside investors and to mislead plaintiffs and other investors into believing that defendants were contributing a proportionate share of capital for the interests retained.[44] In conclusion, the court held: "we also find that defendants' revelation to plaintiffs that defendants had retained a certain percentage of the various wells without informing plaintiffs that the defendants had not contributed proportionate capital constituted a material omission of fact under [the Michigan Securities Act's antifraud provisions]… Certainly, the promoter's representation to a prospective buyer that he had retained a certain percentage of a venture might tend to

[39] Like Alabama and Oklahoma, Michigan is a Uniform Securities Act state and its small offering exemption is similar to both Alabama's and Oklahoma's.
[40] *Prince v. Heritage Oil* at 201.
[41] *Id.*
[42] *Id.*
[43] *Id*. at 201 (emphasis added).
[44] *Id.*

mislead the investor into believing that the investment was sound because the promoter himself invested heavily in it. A reasonably prudent investor would want to know that the promoter in such a situation received his stock without financial investment or at grossly lower prices."[45]

The disparity between what promoters and working interest owners pay for their respective interest in a drilling venture is often determinative of whether a carried interest will be considered a securities sales commission or other form of remuneration for soliciting investors; the effect of which is to void the exemption from state securities laws registration requirements. In *PIC Oil Co., v. Grisham,*[46] the lower court found that PIC made a capital investment of $105,716 in its drilling venture and compared this figure with the capital investment of $661,771.37 in the drilling program from the outside investors noting that PIC retained leasehold interests greater than the combined interests sold to outside investors.[47] Faced with these issues the Oklahoma Supreme Court revisited the carried interest issue and held:

> "In the PIC drilling program, outside investors in the leases paid a 7.1 to 1 ratio for their interests when compared to the capital investment of PIC for its retained interests. And comparing this ratio credit is given to PIC's claims for additional contribution from outside investors.
>
> We hold that the receipt of securities by promoters for prices **grossly below those paid by outside investors amounts to other remuneration.** The effect of the interests retained by the defendants was to dilute the equity paid by outside investors and to mislead plaintiffs and other investors into believing that defendants were contributing a proportionate share of capital for interest retained.
>
> The disproportionate price paid for the leasehold interest by the respective parties reasonably admits only the conclusion that PIC received indirect remuneration for the solicitation of the sale of the leasehold interest to the

[45] *Id*. at 202-203.
[46] 702 P. 2d 28 (Okla. Sup. Ct. 1985)
[47] *Id*. at 32

Grishams. Once such remuneration was paid, the sale could no longer qualify for the limited offering exemption... Accordingly, the securities PIC sold must have been registered with the commission." [48]

Both the *Prince v. Heritage Oil* and the *PIC* cases fixed on the significance of the disproportionate amount of the payments made by the outside investors versus the purported values of the carried interest retained by the developer/operator. In an attempt to resolve just what constituted a grossly different value, the Oklahoma Securities Commission, through its rule making power, modified the availability of Oklahoma small offering exemption to provide for the retention of a carried interest if it was reasonable and customary under the circumstances. Where such interests were found to be reasonable under the circumstances, the exemption would still be met. In short, courts considering whether the small offering exemption, like Oklahoma's and Alabama's, was available in a given transaction must look at the transaction and determine whether the working interests retained exceeded a reasonable fee for the services actually performed.[49]

Wilson v. AL McCord, Inc.,[50] was a case filed after the Oklahoma Supreme Court's ruling in the *PIC Oil Co.* case [where a 7.1 to 1 ratio was found to be grossly disproportionate[51]] but before the Securities Commission's implementation of the new Oklahoma rule took effect. In this case suit was begun for failure to register securities and sought as a remedy rescission. Although the federal district court held that most of the claim was time barred and entered summary judgment, it also held that whether the sale of the working interests was entitled to exempt status was an issue which was reserved for the jury. Jury instructions as to the law to be applied (the law as it was before the modification of the Oklahoma small offering exemption) were given and a verdict was returned in favor of the defendants. On appeal the Tenth Circuit was asked to overturn the

---

[48] *Id*. at 33 (emphasis added).
[49] The presumption here is that the Alabama Securities Commission would also allow the retention of a carried interest where it is reasonable and customary.
[50] 858 F. 2d 1469 (10th Cir. 1988)
[51] *PIC Oil Co., v. Grisham*, 702 P. 2d 28, 33 (Okla. 1985)

jury's finding that the exemption was not available to defendants, based upon the then recent decision in *PIC Oil Co., Inc.* However, during the pendency of its consideration of plaintiff's appeal, the Oklahoma Supreme Court decided *Mayfield v. H.B. Oil & Gas*,[52] on claimed facts nearly indistinguishable from the facts raised by the plaintiffs in *Wilson v. AL McCord, Inc.*

In the *Mayfield* decision the Oklahoma Supreme Court, in apparent reliance upon the new Oklahoma Securities Act rule regarding whether a carried interest was reasonable under the circumstances, retreated from its prior holding in *PIC Oil Co., v. Grisham* and held that the question of whether a developer/operator's 25% carried interest in a "third-for-a-quarter" deal,[53] - a relatively standard arrangement among partners within the oil and gas industry - constituted other remuneration was a question of fact for the jury. The Tenth Circuit followed the most recent pronouncement by the Oklahoma Court, but noted, "[i]t is quite possible that the 25% working interest retained by the issuer at no capital outlay had the effect of diluting the investors' funds. As such, a carried interest could constitute a direct or indirect commission or other remuneration for the sale of securities and if so the sale would not qualify for the limited offering exemption…"[54]

The plaintiffs in *Wilson* maintained that defendants failed to establish that the sale of the working interests was entitled to the transactional exemption in force at the time, which is in most respects like Alabama's Section 8-6-11 (a) (9) exemption except that the Oklahoma exemption permits sales to 32 persons [not the 10 in Alabama] provided that, the seller believes the investors are buying for investment, no public advertising is used and "no commission is paid or given directly or indirectly for the solicitation of any such sale, excluding any

[52] 745 P 2d 732 (Okla. 1987)

[53] *Id.* at 735, In a third-for-a-quarter deal, the operator transfers three-quarters of the leasehold mineral interest in a prospect to another person (or persons) in return for payment of 100% of the costs of drilling and, if successful, completing the test well on the prospect. For example, if the deal included three people plus the operator, each person (other than the operator) would put up one-third of the drilling cost and would receive a one-quarter interest in the well. The operator's quarter interest in the well is its reward for searching for, identifying and leasing the prospect as well as the efforts it exerts in supervising the actual drilling and completion." *Brountas v. Commissioner,* 73 tax rep. 491, 496-97 (1979)

[54] *Wilson v. AL McCord, Inc.*, 858 F. 2d at 1474.

commission paid or given by and between parties each of whom is engaged in the business of exploring for or producing oil and gas…"[55] Like Alabama's Securities laws the burden of proving the availability of an exemption is upon the person claiming it.[56]

The terms of the agreement in *Wilson v. AL McCord, Inc.* required the investors to pay 1.33% for each 1% working interest (the so-called third-for-a quarter" deal), which permitted defendants to retain a 25% carried interest while selling 75% of the leasehold interest to plaintiffs and other investors in exchange for 100% of the drilling and completion costs.[57] This was, defendants claimed, compensation for services rendered, including developing the lease, performing geological studies, securing the necessary contractors, employing workers and supervising the entire operation.[58] In the absence of the superseding holding in *Mayfield*, the Tenth Circuit may very well have found that a third-for-a-quarter carried interest deal was a commission or other remuneration so as to defeat the availability of the Oklahoma small offering exemption from registration. However, the intervening Oklahoma Rule change and the *Mayfield* decision caused the Circuit to send the case back down to the lower court for further review.

The problems with the holdings in *Prince v. Heritage Oil Co., PIC OIL Co. v. Grisham, Wilson v. AL McCord, Inc., Mayfield v. H. B. Oil and Gas* relate to the fact that there are no "commissions or other remuneration paid for **soliciting prospective investors**" in a dry hole. The developer/operator could never possibly receive any monetary interest from a carried interest in an unsuccessful well; a carried interest in a dry hole dilutes no one, as all interests in a dry hole are essentially worthless. Because investors are necessarily solicited to purchase interests in both producing wells *and* dry holes it is quite illogical and inconsistent to assert that a carried interest constitutes compensation in one context – a producing well – and not in another – a dry hole. A developer/operator will get 25% of nothing in one and 25% of something in another. If there is no value to a

[55] Okla. Stat. Tit. 71, Section 401 (b)(15) A (Supp.1978)
[56] Cite to Okla.Act
[57] 858 P. 2d 1469 (10th Cir. 1988)
[58] *Id.*

carried interest in a dry hole then the “compensation” or “commission” or “other remuneration” for solicitation of a dry hole working interest investor could never be paid. A carried interest *only* has value in a producing well, a successful drilling venture. Therefore, it is, or should be, obvious that a carried interest is not paid, directly or indirectly, for the “**solicitation of purchasers**,” rather the carried interest is paid for having developed a successful project; it is a reward to the developer/operator for having successfully selected an appropriate drilling site, relied on sound geology, developed a sound drilling plan and paid the up-front costs attendant to preparation of a ready-to-drill prospect, including general overhead costs. It is compensation for getting it right, much like hedge fund managers or private equity fund managers or managers of investment partnerships - all of who are paid a percentage of the profits generated by their decisions made about what to do with their investor’s money, as evidenced by their investment acumen. These entities regularly sell their interests to Alabama investors and the ASC does not take issue with those offerings, or hasn’t done so publically as yet. In these type investments a carried interest is a profits interest in the partnership, hedge fund or private equity fund, just as a carried interest in an oil or gas well is a profits interest in the drilling venture. In a hedge fund, equity fund or investment partnership a profits interest is given the manager even though there is no corresponding capital interest, or investment, from a taxation standpoint.

The carried interest in hedge funds, investment partnerships and private equity funds is not accompanied by any underlying capital investment, just as it is with a carried interest in an oil and gas drilling venture. A carried interest is a way to compensate the fund managers (and in the case of an oil and gas venture, the developer/operator) for the services they provide to the enterprise. Given that it normally takes 1 to 3 years to develop a ready-to-drill prospect should indicate that the costs of drilling, testing and completing, as set out in the AFE’s, are insufficient to fully compensate a developer/operator for his historic actual out-of-pocket costs. Further, a carried interest is no different in an oil and gas context than it is in a hedge fund context. It is compensation for getting it right and the fact that a carried interest has value is a boon to the investors. Just as is case in a hedge fund context, the value of a carried interest in a drilling venture does not flow directly from the investors; rather it flows directly from the proceeds of a producing well and more closely resembles "a profit in the ordinary sense" than some value derived from the successful solicitation of an investor. A carried interest in an investment vehicle, be it hedge fund, private equity fund or drilling venture is in fact compensation for getting it right, not for the successful solicitation of the investor.

Years after the holdings in the *PIC Oil Co*. and *Mayfield* cases the Oklahoma Securities Act was amended to conform to the updated Uniform Securities Act and there were no real surprises in the new Oklahoma Securities Act. Apparently after the Act's passage someone in the oil and gas business awoke to probable implications on the oil and gas business of the new Oklahoma Securities Act. With an effective date the same as that for the recently enacted Revised Uniform Act, the Oklahoma Securities Division adopted a new Rule under Section 4.15 relating to the payment of commissions in connection with sales of oil and gas interests.[59] The existence of a carried interest in an oil and gas drilling venture should not be a disqualification from the use of the small offering exemption under the ASA. Indeed, the small offering exemptions in both the Oklahoma Securities Act and the Kansas Securities Act (both are Uniform Securities Act states, like Alabama) have been modified by legislative act and agency rulemaking power to provide for a reasonable carried interest. This was done to reflect the economic realities inherent in the independent oil and gas business. Alabama should follow Oklahoma's and Kansas' lead.

Oklahoma has taken this action and promulgated § 11-11-2 that defines "commissions" to negate the strict definitions in the court decisions noted above regarding the phrase "or other remuneration." That language was deleted from the Rule. However, the language does appear in the Oklahoma Act, specifically under the small-offering exemptions and Coordinated Limited-Offering Exemption; thus, the issue of "carried interests" as "other remuneration" is alive

[59] Rule 11-11-2, Okla. Reg. Section 660:11-11-2. *See also*, 3A Vernon's Okla. Forms 2d, Bus. Org. Section 4.15.

and well in Oklahoma, which is a friendly jurisdiction for the interests of oil/gas developers.

Paragraph (a) of the rule defines “commissions” as a “benefit paid or given, directly or indirectly, as consideration for the act of offering or selling a security, whether the benefit is in the form of money, property or is otherwise tangible or intangible.” The rule provides safe-harbors for various types of payments to a sponsor of an enterprise, and on its face, should protect Oklahoma oil and gas developers. An “enterprise” is defined as any entity in which the investors’ rights, interest, or participation constitute “securities” under the Oklahoma 2004 Act. “Sponsor” includes any natural person or entity which is directly or indirectly instrumental in organizing an enterprise or which will manage or participate in the management of the enterprise. However, because of the insertion of the language “other remuneration” in sections of the act, further analysis is needed.

The general categories of payments are (1) benefits arising out of goods or services sold by the sponsor to the enterprise, (2) “carried” or other promotional interests retained by the sponsor, and (3) payments to employees of the sponsor or enterprise who are involved in selling securities to investors. Payments to the developers can run afoul of the act by either scenario (1) or (2). Goods or services sold by a sponsor to the enterprise must be reasonably related to the present or proposed business of the enterprise. Also, the amount or value of the benefit paid or given to the sponsor must be competitive with the price that would have been paid in the same or comparable area to nonaffiliates who are engaged in the business of selling comparable goods or services. For example, a sponsor who reaps a profit on a turn-key drilling contract with his enterprise may be deemed to have received a “commission” if the enterprise could have contracted with a nonaffiliated drilling contractor at a lower price. The same would apply to any mark-up in leases sold investors.

The most problematic issue involves carried interests, because this scenario is the most common practice. A sponsor’s interest is deemed “promotional” when his interest in the revenues of the enterprises is proportionately greater than the capital invested by the sponsor in the enterprise. In those instances, a carried interest will be deemed a commission unless it passes a two-pronged test: (1) the interest must be “reasonable or customary” in the industry in which the enterprise operates or proposes to operate, and (2) the sponsor must have substantial duties unrelated to the sale of a security in connection with the enterprise.

For purposes of the first prong of the test, the rule provides that any promotional interest permitted under applicable guidelines published by the North American Securities Administrators Association (“NASAA”) “shall be presumed reasonable and customary.” However, failure to meet NASAA guidelines will not be fatal if the sponsor can still meet his burden of showing that the promotional interest is otherwise reasonable or customary in his area, or that the interest was not paid for the offering or sale of a security. For example, the traditional “third-for-a-quarter” (sometimes called “25% carried interest”) retained by sponsors in the oil and gas industry is an example of an interest that might be justified on the basis that it is “customary” in the area, despite that the interest probably exceeds the promotional interest that would otherwise be permitted under the NASAA guidelines for registered oil and gas programs. In its simplest form, the “25% carried interest” transaction involves a sponsor assigning 75% of the working interest in a lease to investors while retaining 25% for himself. As compensation to the sponsor for bringing the opportunity to their attention, the investors agree to pay all or part of the drilling costs of the well drilled on that lease.

The amount of the sponsor’s “promotional interest” depends on the extent to which the investors agree to pay expenses. For example, if the sponsor’s interest is carried “to the casing point,” it means that the investors will pay 100% of the drilling costs necessary to determine if the well is successful, and if the logs show the well is a producer, the sponsor will pay 25% of the cost of casing (pipe) and other completion costs necessary to make the well operational. On the other hand, if the sponsor’s interest is carried “through completion,” it means that the investors will pay 100% of the drilling and completion costs. In either case, immediately after completion the operating costs and revenues begin being allocated 75% to the investors and 25% to the sponsor, and this division continues throughout the life of the well irrespective of the amount of return the investors ultimately realize on their investment. Although well depth and a variety of other factors will affect the result, it is safe to say that even a 25% interest carried “to the casing point” usually will exceed the promotional interests permitted under today’s NASAA guidelines. To illustrate, assume a well costs $160,000 to drill to the casing point, and $140,000 to complete. If the sponsor’s interest is carried “to the casing point,” his promotional interest is 13.3%. However, if his interest is carried “through completion,” his promotional interest is 25%. Under the NASAA guidelines, the amount of promotional interest permitted depends on the type of program and on how long the sponsor is willing to wait until he can commence sharing in revenues. If the sponsor of a carried interest program desires to share in revenues commencing with the first sale of production, his promotional interest will be limited to 10%; on the other hand, if prior to drilling the sponsor agrees to subordinate his share of revenues until the investors have been distributed an amount equal to their capital contributions (sometimes referred to as “payout”), his promotional interest may be increased to 25%. Therefore, in order to meet NASAA guidelines in the above example, the sponsor whose interest is carried to the casing point would need to subordinate the portion of his interest that exceeds the guidelines until the investors receive at least part of their money back and the sponsor whose interest is carried through completion would need to fully subordinate his interest in revenues until the investors reach payout. A potential remedy to this issue is for the sponsor to escrow his carried interests with his attorney or with the securities commission until the investors’ returns are realized as prescribed by NASAA guidelines.

The second prong of the “promotional interest” test requires that the sponsor have “substantial duties” in connection with the enterprise that are “unrelated to the sale” of the security. By definition, the rule does not require that the sponsor’s duties be continuing or relate to the operations of the enterprise after its formation. Thus, the landman or geologist who receives a reasonable or customary overriding royalty interest in an oil and gas prospect he helped generate should qualify for the safe harbor even though he will have no further relationship with the enterprise after the well is drilled. A purely “passive” general partner of a limited partnership may have difficulty meeting this prong of the test if he receives a promotional interest without rendering any apparent service to the enterprise either at its formation or thereafter. However, it is arguable that the unlimited liability he bears as a general partner for all the obligations of the enterprise should be sufficient. The same could be said for a "passive" member in a limited liability company or shareholder of a corporation who contractually guarantees all or part of the obligations of his enterprise. The bottom line is this: under Oklahoma's interpretation, if the sponsor had done work, he will likely get this exemption; if he is passive, he will not.

The payment of compensation to employees of the enterprise or its sponsor, including officers, directors, and partners, will not be deemed a "commission" if such compensation is not directly or indirectly related to the offer or sale of a security, the employee is a bona fide employee who has substantial duties that are unrelated to the sale of the security, and the employee's activities involving the offer or sale of a security are strictly incidental to such person's bona fide primary work duties. As noted above, with certain exceptions, a finding that an employee has received a "commission" will be fatal for an offering under certain exemptions. Even if the payment of a "commission" does not cause loss of an exemption, it may still give rise to a cause of action for rescission if the employee has failed to register as an "agent." Because of the headaches, many Oklahoma issuers, who frequently raise capital through the selling efforts of one or more employees in transactions exempt under the Small Offering Exemption or Coordinated Limited Offering Exemption, should consider having such employees register as "issuer-agents." Likewise, in Alabama this course should be considered, if the Alabama Securities Commission follows Oklahoma's lead on the issue of carried interests. This action does create more paperwork and open the issuer to more scrutiny by regulators, but this course would alleviate the devastating effects of rescission.

We are strongly recommending to the Alabama Securities Commission that they follow Oklahoma's lead on this issue. Oklahoma has recognized the economic realities of oil and gas exploration.

When is any Entity a Single "Person" For Purposes of the Numbers Limitation under Section 8-6-11 (a) (9)?

Alabama's small offering statutory exemption only permits the sale to 10 or fewer "purchasers" in any 12 month consecutive period.[60] This limitation of ten purchasers applies to all investors wherever located; that is, the number limitation is a universal ten investors limitation, not just ten investors located in Alabama. It is sometimes easy to count *individual* investors for purposes of the number of purchasers limitation of the exemption, but investor *entities* can prove to be a problem. Given that it is a felony to sell unregistered securities in Alabama, developer/operators should take great pains to get it right. Consider the case of Mr. Smith, an experienced oil and gas investor with a history of investing in a variety of offerings within the Black Warrior Basin. If he elects to take the working interest in both his own name and his wife's name, as tenants in common, does this election count as two persons or only one person for purposes of the 10 or fewer purchaser limitation of the Section 8-6-11 (a)(9) exemption? In *Upton v. Trinidad Petroleum Corporation* there were 14 investors who were offered undivided working interests in the Wallace Well Number Two and plaintiff Upton was the 15th person to be offered such an interest. Among the 14 existing investors who had obviously been offered the interests were Charles D. and Mary Sue Beard. Mr. Beard was the developer/operator of Trinidad; and while it would appear that he was not standing in the need of the protective provisions of the ASA, he was nevertheless counted with his wife as two offerees.[61] While the Alabama exemption in Section 8-6-11 (a)(9) then applied to offerees, not purchasers as it does today, Mrs. Beard was nevertheless counted as one offeree and her spouse was counted as another.[62] Should Beard have even been counted as an investor in the Trinidad program at all? He knew the proposed drill site and presumably he was the person who selected it. Was he standing in need of the

[60] Ala. Code Section 8-6-11 (a)(9).
[61] *Upton v. Trinidad* at 468 F. Supp 333-334.
[62] *Id*.

protective provisions of the ASA? The answer would seem to be no. As a matter of economic reality he should not have been counted as one of the investors for purposes of the numbers limitation of the ASA's small offering exemption. If, as appears reasonable, Mr. Beard alone made the investment decision and used his own funds, Mrs. Beard should not be treated as anything but a recepiant of a gift from her husband and as she paid no consideration for her interests there was never a "sale" of a security to her.

Suppose as well, that Mr. Smith, an experienced oil and gas investor, decides to take ownership of his working interest through a corporate entity, or an LLC, the shares, or membership interests of which, he has also distributed to his spouse and children. How is the sale to be accounted for under the exemption's numbers of purchasers limitation requirements? Is this sale counted as one purchaser? Two? Five? Only one real investment decision was made and only Mr. Smith paid any money. The investment decision was made by an experienced oil and gas investor who was knowledgeable about the risks involving drilling oil and gas wells. As a matter of economic reality this is but one investor.

What happens when, following several successful investments in a drilling company one of its longtime working interest investors decides to let his golfing buddies buy a portion of his interest without telling the developer/operator he has done so - he's been bragging about the money he's making in his oil and gas investments at the country club and finally succumbs to peer pressure from his pals. If he resells portions of his working interest to them has the investor caused the developer/operator to violate the ASA's number of purchasers' limitation? The answer to all these questions could very well be YES.

Developer/operators (issuers) claiming benefit of the statutory Section 8-6-11 (a)(9) exemption, are shackled with the duty to know who is investing in their oil and gas wells. Granted, the case of the experienced oil and gas investor who adds his wife to his ownership of his purchased working interests might be a stretch to count them as two purchasers, just as is Mr. Smith's gift to his wife and children, but it is the issuer who has the obligation to prove the availability of the exemption and at times that can be a real problem.

The question about whether a corporate entity, or LLC, is counted as only one investor is often determined by asking this question: "was this entity specifically created for the purpose of investing in the offered working interests?" If the answer is yes, then each shareholder or member of that corporate entity, or LLC will be counted towards the numbers limitation of the exemption. The reason is quite simple: suppose an investor decides to resell the working interests sold him; he then creates an LLC and sells memberships in that LLC, to 100 of his friends. As a matter of economic reality, those securities have come to rest in many investors' hands, the result of which is a public offering of securities. That is why the Section 8-6-11 (a) (9) exemption is conditioned upon the issuer's knowledge that each of its working interest owners is purchasing the offered securities for "investment," which in this context means he is buying the securities from the issuer without any view towards a subsequent distribution of those securities.

If oil and gas developers/operators do not now have as a part of their letter agreement with working interest owners, a signed representation from them that they are buying the offered securities for their own account without any view to any subsequent distribution, those oil and gas developer/operators should add such a representation to their letter agreements immediately.

A more problematic question arises when an entity, such as ABC, LLC which was specifically created to invest in the developer/operators first drilling programs invests in the second, third and fourth drilling programs. ABC, LLC has 15 investors upon its first investment and the same 15 persons are in ABC, LLC in investments two through four. If the second drilling program is offered to the developer/operator's investors in the first drilling program is ABC, LLC to be counted as 1 or 15 investors. ABC, LLC was not created for the purpose of investing in programs two through four. It was created for the purpose of investing in the first program – not programs two through four. The investors in

ABC, LLC are probably knowledgeable about the developer/operator and are reasonably satisfied with their first investment, the developer/operator management of the enterprise and with his integrity, knowledge and skill. Logic dictates that ABC, LLC was not created for the purpose of investing in drilling programs two through four and in fact it was created for the purpose of investing in the first drilling venture. In many respects the investors in ABC, LLC are like existing shareholders: they know management, understand the risks of the enterprise and have expended funds from which profits, if any, were derived from the developer/operator's expertise and management. While not an exact fit, investors who pool resources in an entity to participate in several drilling programs are more akin to shareholders who are offered investments in the same company in which they already own the shares. They know the management (developers/operators of an oil venture), they know the risks (nothing in the oil and gas business is certain), they know how this oil and gas developer/operator conducts his business and they know whether the new opportunity is a development or a wildcat venture. These repeat investors would surely not throw good money after bad. The JOA is presumably the same as the original one, but the contract area may be different. In short, the entity created for the purpose of investing in the first drilling venture should be counted as 15 for purposes of counting investors in that venture, but thereafter a good case can be made for counting that entity as only one investor purchaser for the purposes of the numbers of purchasers limitation contained in the ASA's Section 8-6-11 (a) (9) small offerings exemption.

Care should be taken with the SEC and state securities requirements that working interests sold under the small offering exemptions be sold only to experienced investors; those capable of fending for themselves in oil and gas investments and who possess the requisite knowledge of the risks attendant to such investments. A developer/operator should document the investment experience of their working interest owners. The easiest way to do that is to have the prospective investor sign a document to the effect that he or she possesses the requisite experience and that they can afford the risk of the loss of that investment, but sometimes that is a difficult document to get executed by a prospective investor.[63]

In *Wilson v. AL McCord, Inc.,* supra. two experienced oil and gas investors took title to their working interests in the names of their spouses and then sued the developer/operator contending that the issuer could not proffer any evidence concerning the investment sophistication of their spouses as required under the securities laws' exemption provisions. In this case, the court did not accept plaintiffs' argument that their spouses were "investors" entitled to the protections of the securities laws.[64] The court reasoned that they took title in the names of their unsophisticated spouses, those experienced investors (the ones who actually made the decisions to purchase the working interests) had in essence attempted to secure a "put" as follows: "the path would be laid for every sophisticated investor to purchase unregistered securities, transfer them to an unknowing spouse, and speculate at the expense of the honest developer." [65]

Statute of limitations Questions.

Under Alabama law investor claims of unregistered sales of securities must be made within two years of the date of sale.[66] Alabama defines a "sale" to include "every contract of sale of, contract to sell, a security or interest in a security for value."[67] The date of the sale of undivided working interests in oil and gas securities is the date upon which those working interest owners executed an agreement to participate in the drilling of a well, or wells, in the event of a multiwell drilling program. In *Adams v. Smith,*[68] the Oklahoma Court of Appeals held that the sale of fractional working interests in an oil well occurs upon the execution of the letter agreement as the rights of the parties became fixed at that time. The Court rejected the idea that where a party makes several payments to

[63] In *Upton v. Trinidad Petroleum Corp.* 468 F. Supp. 330, 334 (N.D. Ala. 1979) *aff'd on other grounds*, 652 F. 2d 424 (5th Cir. 1981) the District Court noted: "Defendants did not require written statements of investment interest from the purchasers, and defendants did not place a restrictive legend on the documents evidencing the interests in Wallace Well Number Two."
[64] *Wilson v. AL McCord, Inc.,* 858 F. 2d 1475.
[65] *Id.*
[66] The Alabama Securities Commission has a 5 year period during which they must bring criminal charges for violations of the Alabama Securities Act.
[67] Ala. Code Section 8-6-2 (8) (1975).
[68] 734 P. 2d 843 (Okla. App. 1986)

obtain a security, the sale was continuing, saying "the violations which commence the running of the statute [of limitations] must be the first violation. Otherwise, the statute of limitations would be rendered meaningless. This is particularly true where … the plaintiff has control over succeeding violations, i.e., by making further installment payments."[69] The 10th Circuit in *Wilson v. AL McCord, Inc.* agreed with this reasoning, "[i]n this instance, *Adams* instructs us that any violation of [the Oklahoma Securities Act's registration requirements] accrued when the plaintiffs signed the letters of Agreement. At that point the sale of unregistered securities had occurred. Each party's rights were established. There is nothing in the record to indicate that the defendants sought to conceal the registration status of the [well's] working interests, thereby possibly tolling the accrual of the claim."[70] Oklahoma's Securities Act's statute of limitations for a sale of unregistered securities is three years from the date of sale. The ASA's statute of limitations for unregistered sales of securities is two years from the date of sale.

Equitable Tolling and Failure to Register Claims under Section 8-6-4

The lynchpin of equitable tolling - the defendant's ability to conceal from a plaintiff the right to bring a lawsuit - is really not present In a Section 8-6-4 failure to register securities action because whether a security is registered is a matter of public record. In other words, the policy underlying equitable tolling - that the defendants concealment of his wrongdoing has caused the plaintiff to be unaware of his cause of action despite his reasonable diligence - is inapplicable. A defendant who falsely represents that a security is registered - or, exempt from registration - cannot prevent an investor from discovering the true facts as to the lack of or requirement of its registration. A telephone call to the Alabama Securities Commission will reveal whether or not a security is registered or exempt from registration.

If an action is brought alleging that a material misrepresentation either in the offering documents or registration statement or the sale itself has occurred,

---

[69] *Id*. at 846 (Quoting *Bryant v. Uland*, 327 F. Supp. 439, 447 (S.D. Tex 1971)

[70] *Wilson v. AL McCord, Inc, at 1475*. Indeed, given that it is easy to determine whether a security is registered – a phone call to the Alabama Securities Commission can resolve that issue – any question regarding the registered or unregistered status of working interests purchased is very hard to conceal.

the statute of limitations does not begin to run until the plaintiff discovers that fraud. However, there was no language creating a discovery rule of an action where a violation of the ASA is brought alleging that unregistered securities were sold and the legislature expressly limited causes of action for failure to register to only two years after the date of the sale. The legislature differentiated between, on the one hand, actions based on a fraud and, on the other hand, a strict liability action based upon the sale of an unregistered security. If the Legislature had wanted to include a discovery rule for unregistered sales of securities, it would have done so. Its omission in that regard indicates the intention to preclude application of any discovery rule in an unregistered securities claim. Purchasers of unregistered securities have only two years from the date of sale to bring a claim under the ASA.

Integration of offerings

If an investor agreed on day one to participate in a five well drilling program and the investor put up the funds to drill and complete the last well 20 months after signing the letter agreement and Joint Operating Agreement ("JOA"), the statute of limitations began to run on day one, not 20 months later. The *Wilson v. AL McCord* holding teaches at least that much. However, this holding raises several additional questions, particularly questions of integration[71] of offerings; that is, whether a subsequent offering should be combined, or aggregated with the offering that occurred on day one. The concept is important for purposes of the number of purchasers limitation in the Section 8-6-11 (a)(9) exemption, the statute of limitations and, of course, whether the offered securities qualify for the small offering exemption.

[71] *Brown v. Earthbound Sports Usa*, 481 F. 3rd 901 n. 7 (6th Cir. 2007) (stating "[T]he determination as to whether separate sales of securities are part of the same offering (i.e. are considered integrated) depends on the particular facts and circumstances… The following factors should be considered in determining whether offers and sales should be integrated for purposes of the exemption under Regulation D: (a) Whether the sales are part of a single plan of financing; (b) Whether the sales involve issuance of the same class of securities; (c) Whether the sales have been made at or about the same time; (d) Whether the same type of consideration is being received; and (e) Whether the sales are made for the same general purpose.") There exists under federal law a great deal of law relating to whether or not a particular securities offering is to be integrated with another offering of securities. This is, however, not the case with the Alabama Securities Act.

The small offering requirements of the Alabama exemption permit sales to no more than 10 purchasers "within any 12 month consecutive period."[72] Are developer/operators required by this time period limitation to wait 367 days following the last sale made in a prior drilling program before soliciting working interest owners in another and different drilling program? The answer seems to be yes, but the question turns, among other requirements, on how many investors were sold interests in the prior drilling program and the current drilling program. For example, if there were no more than five investors in the first well, the developer/operator might be permitted to solicit up to five additional investors in the second well, assuming all of the other conditions of the exemption are met. Thus, even if the two offerings were to be integrated there would be no violation because there were only 10 investors who were sold interests in both wells.

What if the letter agreement and JOA executed by investors in the initial drilling program (the program that commenced on day one) contemplated or specifically referenced even, the investors' potential subsequent participation in a development drilling program on leases which were proved up by successful drilling in the initial drilling program; after all it is only fair that the investors whose funds were used to prove up adjacent leases, or to exploit leases held by production because of the initial drilling program's success, be entitled to exploit the opportunities derived from the use of their investment dollars. If the letter agreement and JOA specifically reserved this potential opportunity to the investor it would seem that the drilling of the development program, even though more than a year after the investors' execution of the letter agreement and JOA would be integrated without any adverse impact upon the issuer's claim to a valid exemption on day one. Again, assuming all the other conditions of the exemption are met. The understanding between the developer/operator and the investor, including this possible addition to the initial exemption claim and participation in a subsequent development drilling venture, were memorialized and agreed to when the investor executed the letter agreement and JOA in the initial drilling program on day one. However, if there were 10 working interest owners in the

[72] Ala. Code section 8-6-11(a)(9) (1975).

initial exploratory drilling program, oil and gas developer/operators should take care when they attempt to add additional investors in the subsequent development drilling program.

Suppose as well that an investor, because of a change in financial circumstances, or for some other reason unforeseen on day one, is unable to participate in all of the five wells contemplated in the initial drilling program; the program executed by him on day one. Usually, but not in every instance, the JOA will contain a farm out or non-consent contingency. The occurrence of such a contingency may not prove a problem if the other investors in the same five well drilling program are the ones who agree to take up the defaulting or non-consenting working interest owners' interest in a farm out agreement, all as laid out in the letter agreement or JOA, which was executed on day one. But what happens if a third party – one who did not execute the letter agreement or JOA on day one – agrees to take up the defaulting working interest owners' rights to participate in the remaining wells in the five well development drilling program, again, all as was laid out in the letter agreement and JOA. Does the addition of this third party, or third parties, effectively void the Section 8-6-11 (a)(9) exemption and thus convert the entire offering into a sale of unregistered securities? If the addition of the third party results in more than 10 investors, provided that the farm out offer to participate is made more than 12 months after the last sale of the initial drilling program, the plain language of the exemption would not seem to require that the development drilling program be registered. Other than giving up some of his rights to participate in all five of the wells, the non-consenting investor does not give a thing of value for his continued participation in the drilling program, albeit he does receive a reduced percentage of production following the new investors' receipt of 100% of his payment of the non-consenting working interest owners' drilling and completion costs. These questions have not as yet been answered, but if there is a risk of going forward with the addition of third party farm out investors, or purchasers of non-consenting interests by additional investors, it is advisable to seek a written opinion from the Alabama Securities Commission before taking on any farm out investors, at least where the developer/operator is close to the ten purchaser limitation.

Can a developer/operator offer working interests to up to 10 investors in an exploratory drilling program and within the 12 consecutive month period offer an additional 10 investors working interests in a different development drilling program? While nothing is certain in the oil and gas drilling business, there are different risk factors in each of the offered programs: one is a wildcat venture and the other seeks to exploit leases which have been proven, at least from drilling on adjacent sites, and may be said to have a higher degree of chance for a successful well. While the risks involved in each program might seem to be different, and may very well not be “a part of a single plan of financing” and not made “for the same general purpose” as the wildcat drilling venture,[73] both would involve the same general purpose (an attempt to discover exploitable minerals), may also involve the same class of securities (the sale of working interests) and would involve the receipt of the same type of consideration. Thus, the two programs could be integrated. However, each drilling program would seem not be a “part of a single plan of financing,” and may not “have been made on or about the same time”.[74] Under SEC interpretations, Regulation D offerings of sales within a six-month period are presumed to be integrated, assuming the integration factors are satisfied.[75] Given that Alabama’s small offering exemption specifies a 12 month period, it is unlikely that Alabama will follow the 6 month integration period contained within Rule Regulation D. Developers/operators will be well advised to keep at least 12 months between their fund raising attempts.

Federal Securities law preemption of the ASA’s registration requirements

Under no conceivable set of circumstances, however, should an oil and gas developer/operator attempt to make a claim for the Section 8- 6–11 (a)(9) small offering for exemption under the ASA where that developer/operator engages in

[73] See, *Brown v. Earthbound Sports Usa, Inc.* 481 F.3rd 901 n. 20 (6th Cir. 2007).*See also* footnote 71 and accompanying text.
[74] *Id*.
[75] *Id.*

a public securities distribution – the use of mass marketing, cold calling prospective investors or use of public advertising, including offers to all comers on websites or on the internet. Use of such public advertising will automatically bring down the wrath of the Securities Commission, eliminate any claim to the small offering exemption, and subject the issuer and its control persons to strict liability. In short, the issuer will have given its investors a two year “put”. While the federal JOBS Act changed the requirements of Regulation D’s Rule 506 to permit public advertising, no Alabama developer/operator should desire to become a test case for either the SEC or the Alabama Securities Commission. It is much too early to gauge the reaction of the SEC or the Alabama Commission to the public offering changes to Rule 506 offerings.

Alabama’s self executing small offering exemption is fraught with potential pitfalls for oil and gas operators. So too are claims to the benefit of the preemptive provisions of Reg. D’s Rule 506. The mere fact that a claim to the federal preemptive provisions of Rule 506 is made and a Form D filed with the SEC provides no guarantee of the absence of regulation by the Alabama Securities Commission and failure to register civil liability under Section 8-6-19(a) and (b). A valid claim to the broad preemption of state securities laws contained in Rule 506 requires that the party claiming the availability of the Rule 506 exemption “establish that the exemption applies and that all conditions of the exemption have been satisfied.”[76] But it was the Alabama Supreme Court in *Buist v. Time Domain Corp.*,[77] that first required defendants claiming the Rule 506 preemption for their private offering to prove that the challenged securities actually qualified for the Rule 506 federal exemption.[78] This case and many others that followed it have established that the Federal Rule 506 exemption must be proven in order to avoid state law failure to register claims. Conclusory assertions of preemption are not satisfactory, however, as the claim of Rule 506 preemption is an affirmative defense to a state securities claim of the sale of unregistered securities. As the Alabama Supreme court noted the “…Rule 506 exemption and preemption are

---

[76] *Brown v. Earthbound Sports Usa, Inc*. 481 F 3rd at 910 (citing *AFA Private Equity Fund v. Miresco Inv. Servs.*,No.02-74650, 2005 WL 2417116 at *9 (E.D. Mich. Sept. 30, 2005)

[77] 926 So. 2d 290, 295-98 (Ala. 2008)

[78] All the terms and conditions of Rules 501 and 502, 17 C.F,R Sections 203.501 – 502, must be met

functionally equivalent" and a "defendant can demonstrate that the Securities Act [of 1933] preempts the ASA [Alabama Securities Act]because the transactions in question are exempt from the registration requirements of the Securities Act."[79] Thus, a failure to comply with the requirements of Rule 506 "voids" the exemption and thereby eliminates the possibility of preemption of the registration requirements of the ASA. "In other words, the exempt status of the sale of the securities that deviates from any of the material commitments made in its Form D filing is repealed retroactively."[80]

Rule 506 of Regulation D

Rule 506 of Regulation D is considered a "safe harbor" for the private offering exemption of Section 4(2) of the Securities Act of 1933. Companies using the Rule 506 exemption can raise an unlimited amount of money. A company can be assured it is within the Section 4(2) exemption by satisfying, among other requirements, the following standards:

- The company cannot use general solicitation or advertising to market the securities[81];
- The company may sell its securities to an unlimited number of "accredited investors"[82] and up to 35 other purchases. But all non-accredited investors, either alone or with a purchaser representative, must be sophisticated—that is, they must have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment;
- Companies must decide what information to give to accredited investors, so long as it does not violate the antifraud prohibitions of the federal securities laws. But companies must give non-accredited investors

[79] *Buist v.Time Domain Corp.*, 926 So. 2d at 296.
[80] *Id*. at 298.
[81] The prohibition against general solicitations was eliminated by Title III of the JOBS Act to permit public advertising, but the reaction of the state securities regulators, and the SEC, to these changes cannot be predicted. For example, a failure to register investigation may very well become a securities fraud investigation.
[82] An accredited investor is "any natural person whose individual net worth, or joint net worth with that person's spouse, exceeds $1,000,000." SEC Rule 501 (a)(5), 17 CFR 230.501 (a)(5). The investor's primary residence is excluded as an asset. Also included as an accredited investor are "persons who had a individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year."17 CFR Section 230.501 (a (6).

disclosure documents that are generally the same as those used in registered offerings. If a company provides information to accredited investors, it must make this information available to non-accredited investors as well;

- The company must be available to answer questions by prospective purchasers;
- Financial statement requirements are the same as in Rule 505[83]; and
- Purchasers receive "restricted securities", meaning that the securities cannot be sold for at least a year without registering them[84].

Common Misrepresentations and Omissions of Material Fact in Oil and Gas Offerings.

Investor claims

A material fact is one that would be considered by a reasonable investor in the total mix of information provided in connection with the offering.[85] If there is a doubt as to whether a fact is material or not; it is probably material. Over the years there have been numerous cases wherein it is alleged that certain facts were either misstated or omitted in offerings of fractional undivided working interests, oil and gas drilling limited partnerships and other delivery mechanisms for oil and gas drilling ventures. Some of them are set out below.

In *Upton v. Trinidad Petroleum Corp.*[86], plaintiff claimed that the Developer/operator failed to disclose the following: (1) that in 1964 the developer/operator and Trinidad Petroleum Corp. had been permanently enjoined from selling unregistered securities by the SEC; (2) the price of the turnkey drilling contract; (3) the price of the turnkey drilling contract was

[83] For offerings up to $2,000,000 an audited balance sheet within 120 days of the offering is mandated; for offerings up to $7,500,000 additional financial information is required to be disclosed.

[84] This is best done by a specific statement in the investor agreement letter or stated in the JOA which confirms that the investor is buying the working interests for his own account and makes the investment without any view towards a subsequent distribution.

[85] In *Basic, Inc. v. Levinson,* 485 U.S.224, 231-32 (1988) the Supreme Court held that a statement is "material" if there is a substantial likelihood that a reasonable investor would consider the information that was misstated or withheld significant, or that inclusion of the omitted fact would have altered the "total mix" of information available to investors. Issues relating to whether a fact is material are considered a mixed question of law and fact to be determined by the jury. *See also*, *ABC Arbitrage v. Tchuruk*, 291 F.2d 336, 359 (5th Cir. 2002).

[86] 468 F. Supp. 330 (N.D. Ala. 1976), *aff'd on other grounds*, 652 F.2d 424 (5th Cir. 1981).

substantially less than the amount of money being raised from investors;(4) the administrative costs and general overhead costs of Trinidad Petroleum had been taken out of the money supplied by the investors; (5) through an affiliated company, the developer/operator was making a $3,000 profit on the assignment of the leasehold interest for the tract of land containing the wells to be drilled; and (6) the developer/operator's personal business history or a history of his past drilling efforts.[87] The court did not opine on the materiality of all of the plaintiff's fraud claims, but opined that two of them did constitute material omissions, stating that "[d]efendant's failure to disclose either that he had been enjoined by the SEC from selling unregistered securities or that the price of the turnkey drilling contract was substantially less than the amount of money being raised from investors constituted material omissions of fact which made defendant's statement, as a whole, misleading."[88] The existence of a prior securities injunctive order is so obviously material that to omit it constitutes fraud.[89] The omission to disclose the existence of an SEC injunction is also evidence of scienter within the meaning of a 10b-5 fraud claim.[90] The court in the *Trinidad Petroleum* case did not address the alleged omission of the $3,000 markup on the assignment of the leasehold interest for the tract of land containing the wells.

In the *Mills v. Electric Auto Lite Co*., [91]a material misstatement or omission of fact was defined as one which a reasonable investor might have considered important to his investment decision.[92] Reliance on the *Mills* decision prompted the Michigan Court of Appeals in *Prince v. Heritage Oil Company*[93] to rule that the failure to disclose the existence of a grossly excessive carried interest was a material omission as follows: "[c]ertainly, the promoter's representation to a prospective purchaser that he had retained a certain percentage of a venture

---

[87] *Upton V. Trinidad Petroleum Corp.* 468 F. Supp. At 333.
[88] *Id*. at 337.
[89] *Wilson v. Southward Investment Company*, 675 SW 2d 10, 14 (Ky. App 1984) ("As to rescission, we hold that the seller is duly obligated to tell a prospective buyer of pending litigation. We determined that there is a violation of the material omissions provision of the Federal Securities Act when an offeror fails to inform the purchaser of the securities that it had been enjoined from selling unregistered securities by the regulatory authorities.")
[90] *Id*.
[91] 396 U.S. 384, 90 S Ct 616, 24 L.Ed 2d 593 (1970).
[92] *Id.*.
[93] 109 Mich. App. 189, 311 N.W. 2d 741 (1981)

might tend to mislead the investor into believing that the investment was sound because the promoter himself invested heavily in it. A reasonably prudent investor would want to know that the promoter in such a situation received his stock without financial investment or at grossly lower prices."[94]

SEC Cases relating to Private Offerings of Oil and Gas

The number of SEC fraud cases related to private placements of oil and gas ventures has averaged more than 20 per year since 2006. State securities regulators report a similar increase in cases over the past five years.[95]

In *SEC v. Wellco Energy, LLC*[96] the SEC alleged promoters misrepresented the investors' funds would be used to pay for all and gas wells when, in fact, 58% of the money raised went to pay sales fees as well as the promoters personal mortgage and child support.[97] In *SEC v. Petroleum Unlimited, LLC*[98], the SEC alleged misrepresentations were made about the use of investor funds, since only $534,000 of the $2.9 million raised from investors was used for oil drilling. In addition to failing to mention that sales fees equaling 49% and 74% of the investments would be paid; the SEC alleged investor funds were also used to pay the promoter directly and through related companies, like the drilling company[99]. Investors were told, without any reasonable basis, that they could expect returns of 14% to 141% a year. Instead, 81% of the money raised was used to pay for

[94] *Id.*
[95] A recent alert by the Utah Division of Securities illustrates the State Securities Regulators commitment to monitoring Oil and gas investment opportunities. See Division of Securities Top Investor Threats to Consumers, October 21, 2013. ("Investments in oil and gas drilling programs typically involve a high degree of risk and are suitable only for investors who can bear the risk of loss of the entirety of their principal. Some promoters will conceal these risks, using high pressure sales practices and deceptive marketing practices to peddle worthless investments in oil wells to the investing public. There are active investigations into suspect oil and gas investment programs in more than two dozen states and in every region of the U.S. and Canada. …") See, http//utahpulse.com/index.php/features/business/396-division-of-securities-releases-top-investor-threats-to-consumers-businesses.
[96] SEC Litigation Release No, 21040, May 15, 2009, http/www.sec.gov/litreleases/2009/Ir21040.htm. *See also,* "Investor Alert, Private Oil and Gas offerings", SEC Pub. No. 142 (4/13)
[97] *Id.*
[98] SEC Litigation Release No. 21808, January 12, 2011, Http//www.sec.gov/litreleases/2011/Ir21808.htm. *See also,* "Investor Alert, Private Oil and Gas offerings", SEC Pub. No. 142 (4/13)
[99] *Id.*

expenses other than oil drilling, including huge sales fees.[100] In another case, *SEC v. Provident Royalties, LLC*, the SEC alleged that Provident raised 485 million through various offerings from 7,700 investors nationwide promising high returns and misrepresenting how investor funds would be used[101]. Investors were told that 86% of their funds would be for oil and gas investments.[102] The SEC alleged that, instead, and undisclosed to investors, a portion of the investor funds was used to pay dividends and returns of capital to earlier Provident investors.[103]

In *SEC v. Hartmut Theodor Ro*se[104] the promoters were alleged to have told investors that oil and gas production was about to start when many of the wells were actually marginal or even dry[105]. The promoters had failed to disclose that their own geologists had said not to proceed with the completion of the offered wells.[106] Additionally, the promoters misrepresented the success of prior wells to raise funds for new wells and touted the "low risk" opportunity as a "once in a lifetime" offer.[107] The SEC further alleged that the promoters had collected over $10 million from 300 investors nationwide.[108]

The SEC alleged in *SEC v. Hilton* that the promoter raised $3.3 million from 176 investors in several offerings by falsely representing the success and prospects success for success of various wells and the expected returns for investors.[109] The promoters had falsely told investors that Exxon Mobil had previously drilled in an abandoned the oil field because it lacked the technology to exploit it, but the venture now had the necessary technology to extract oil from the abandoned field.[110] Similar allegations were made by the SEC in *SEC v. Sunray*

---

[100] *Id.*
[101] SEC Litigation Release No. 21118, July 7, 2009, http//www.sec.gov/litigation/litreleases/2009/lr21118.htm, See also, "Investor Alert, Private Oil and Gas offerings", SEC Pub. No. 142 (4/13)
[102] *Id*.
[103] *Id.*
[104] SEC Litigation Release No. 21031, May 8, 2009, Http//www.sec.gov.litigation/litreleases/2009/lr21032.htm. See also, "Investor Alert, Private Oil and Gas offerings", SEC Pub. No. 142 (4/13)
[105] *Id*.
[106] *Id.*
[107] *Id.*
[108] *Id.*
[109] "Investor Alert, Private Oil and Gas offerings", SEC Pub. No. 142 (4/13) at P. 5.
P. 5.
[110] *Id.*

Oil Co. were the promoter touted his company's "50 years of experience," but failed to tell the same investors that the company was actually formed much more recently and that his previous company had filed bankruptcy after being assessed over $700,000 in penalties for failing to plug abandoned wells it operated in Texas.[111] The promoter was also charged with the sale of unregistered securities. This promoter raised $1.14 million from 52 investors in ten states[112].

These and other filed cases evidence the SEC's current concerns with, among other things, the following: undisclosed use of proceeds, oil and gas ventures where the promoter makes money from the investors even if the well proves to be a dry hole; use of proceeds; related party transactions, and, the prior experience of the developer/operator.

State Securities Regulators Concerns

The North American Securities Administrators Association (NASAA) is the organization of all state regulators in the United States, Canada, Puerto Rico and Guam and is very active in defending the rights of investors, pursuing securities violators, prosecuting securities fraud and seeking out those who sell unregistered securities. Alabama is one of its most active participants. NASAA regularly publishes Investor Alerts touching on fraudulent activities currently in vogue. Set out below are some of the items published in NASAA's checklist for how to avoid being swindled in oil and gas deals[113]:

1. Ask if the offering is filed with the office of the state securities regulator in your state or the state in which the promoters are located. If the promoter claims that the offering is exempt from registration requirements in the state in which the offers and sales are made, find out which of the exemptions is claimed and the terms of

[111] SEC Litigation Release No. 19737, June 23, 2006, Http//www.sec.gov./litigation/litreleases/2006/lr19727.htm. See also, "Investor Alert, Private Oil and Gas offerings", SEC Pub. No. 142 (4/13)
[112] *Id.*
[113] See, http//www.nasaa.org/6782/oil-gas-investment-fraud/

the exemption. Contact the state securities agency to confirm that the offering is indeed exempt.

2. If it is a legitimate deal, the salesperson will not be reluctant to answer questions and provide written explanations to questions. Ask the name of the person offering you the security, where he is calling from, and his background, particularly in other oil and gas ventures. Ask what commission and/or other compensation the salesperson will receive. Contact your state securities agency to find out if the promoter or salesperson has been sanctioned for previous violations of the securities laws.
3. Ask the names of the principals of the company or the general partners offering the security, their backgrounds and experience in the oil and gas industry, and how long they have been associated with the company. Find out the history of the company, its capitalization, assets and retained earnings. What contingent liabilities does it have from other ventures? Does it have sufficient funds to cover unexpected costs? Find out the company's or general partners' history in drilling operations. In particular, ask how long it has been in the oil and gas business, the number of wells drilled, the number of wells completed as producing wells, and whether the company retained interests in the wells it drilled.
4. Make sure funds raised are kept in a separate escrow account until used and that they won't be co-mingled with other funds. Also, be certain the funds will not be used for purposes other than those specified. Ask how much money is to be raised and the cost per fractional interest. Determine if conflicts of interest involving the promoter are disclosed. All of the above information should be contained in a prospectus or "offering documents" that the promoter must furnish potential investors before they commit their funds.
5. Secure a legal description of the property on which the program is to be drilled. How and when was it acquired? Is the principal selling the lease to the venture at the acquisition costs, and if not, how much profit is being made? As for description of surrounding property, including local well completions and a geologist report on the area. As for disclosure of the person(s) selling the lease, the cost of the lease and any relationship between the lessor and the operator. Insist on seeing a copy of the operator's contract with the promoter.

Rescission Offers

No person may bring an action under section 8-6-19 if he received a written offer to refund the investment amount, plus interest at 6% per year from the date of the investment, and failed to accept the offer within 30 days of its receipt.[114] The purpose of this section is "to allow parties to avoid litigation and quickly settle their differences."[115] In order to foreclose future litigation, an offer of rescission must comply with the statutory requirements.[116] Alabama's Section 8-6-19 (e) requires only that the offer to purchase be made in writing, be made prior to the institution of any action, offer to repay the amount invested plus interest, and be open for 30 days after receipt. The rescission section under the ASA does not identify who has to make the rescission offer in order to cut off the buyer's right to sue, but the statute seems to suggest that the issuer must make the repurchase offer. However, the majority shareholder or other control person could make the offer for the issuer. The effect of acceptance or rejection of the offer is the same regardless of who makes the offer; that is, the buyer loses the right to sue under the ASA in connection with the transaction rescinded.

Other than the requirements discussed above, Section 8-6-19 (e) does not mandate that specific disclosures be made. The Fourth Circuit Court of Appeals in *Brockmann Industries Inc. v. Carolina Securities Corp.*[117] a case construing South Carolina's rescission offer statute, which is virtually identical to Alabama's, indicated that all the offeror need do is meet the express terms of the statute.[118] Other cases and authors suggest that additional requirements must be met to make a rescission offer effective against subsequent litigation.[119] The Fifth Circuit Court of Appeals has indicated that the offer must be unconditional and accompanied by a demand for the return of securities. [120] The source and amount of funds required to effect the repurchase, the federal income tax consequences to the buyer/offeree, the reason for making the repurchase offer and the effect upon the offeree/buyer's right to sue if he elects to accept the repurchase offer have all been suggested as disclosures which might be made in order to effect a valid rescission offer, but the language of the statute does not require that such disclosures be made.

---

[114] Ala. Code Section 8-6-19 (e) (1975)

[115] *Merchant v. Oppenheimer & Co.*, 568 F. Supp 639, 642 (E.D. Va. 1983) (construing VA. CODE ANN. Section 13.1-522 (d) (1989), which is virtually identical tp Section 8-6-19 (e)), *aff'd in relevant part sub nom* Dixon v. Oppenheimer &Co., 739 F. 2d 165 (4th Cir. 1984).

[116] *Brockman Indus. V. Carolina Sec. Corp.,* 677 F. Supp. 430 (D. S.C. 1987) *aff'd,* 861 F. 2nd 798 (4th Cir. 1988) (Construing S.C. CODE Section 35-1-1530 (Law Co-op. 1976, which is virtually identical to Ala. Code Section 8-6-19 (e)).

[117] 861 F. 2d 798 (4th Cir. 1988)

[118] *Brockmann Indus.*, 861 F. 2d at 801; *see also Hayden V. McDonald*, 742 F.2d 423, 435 (8th Cir. 1984) (" sellers of such securities…may cut off rescission liability by making the repurchase offer as provided IN Minn. Stat. Ann, Section 80A.23(8) (West Supp. 1984)").

[119] See Rowe, *Rescission offers under Federal and State Securities Law*, 12 J. Corp. L. 383,424 (1987); Bromberg, *Curing securities Violations: rescission Offers and other Techniques*, 1 J. Corp L. (1975)

[120] *Meyers v. C & M Petroleum Producers, Inc.*, 476 F. 2d 427 (5th Cir.), *cert. denied* , 414 U.S. 829 (1973).

In a rescission offer made to cure multiple violations, such as sales made of differing securities by an unregistered sales agent, the buyer or investor is permitted to rescind or retain each of the securities sold him in violation of the securities laws.[121] The option to retain some illegally sold securities and to elect to rescind others lies solely with the buyer. Rescission offers that require the buyer to rescind "all or none" of the illegally sold securities are ineffective to avoid liability because each and every sale in violation of the ASA is actionable by itself. In short, working interest owners in a variety of prior unregistered oil and gas offerings may elect to rescind their purchases of interests in dry holes and keep their ownership in the producing wells.[122]

Conclusion

The securities laws, both federal and state, are replete with pitfalls for the unwary. Oil and gas developer/operators desiring to sell working interests in Alabama should first obtain counsel from experienced securities lawyers before offering any interests within the state. The regulatory risks to be encountered in Alabama far outweigh any short-term benefit from the acquisition of working interest investors.

The Alabama Securities Commission is among the leaders in criminal enforcement of the securities laws, if not the leading securities regulatory agency, in the United States, including the SEC. They annually obtain more criminal convictions for securities violations than virtually any other state, or federal law enforcement agency. They are aggressive and do not tolerate companies that disregard the Alabama Securities Act. Having said that, the Alabama Securities Commission is, however, fair minded and desirous of assisting issuers and oil and gas developer/operators who seek out their advice and counsel.

.

[121] *Piantes v. Hayden-Stone Inc.*, 30 Utah 2d 110, 514 P. 2d 529, 530 (1973) *cert. denied* 415 U.S. 995 (1974); *In re Republic Mineral Corp. Sec. Litig.,* No. MDL 686 (D. Nev. Mar. 14, 1990) (in the discussion accompanying order dismissing various claims, court stated that refusal to accept "all or nothing" rescission offer did not terminate plaintiffs rights); *In re McDowell,* [1989-1990 Transfer Binder] Blue Sky Law Rep. (CCH) Para. 72,925, at 73,572 (S. D. Ill. 1987)("when there have been separate transactions, the investor may choose to rescind only those that have been unprofitable").

[122] See, generally, Krebs and Donaldson, *Securities Litigation in Alabama: Open Shirts, Gold Cains and Pinkie Rings – a Guide for Widows and Orphans*. 30 Cumberland Law Review 481 (1990).