

Chapter 15

Securities Concerns in the Offering of Interests in Oil and Gas Investments

Marc R. Weintraub¹
Steptoe & Johnson, PLLC
Charleston, West Virginia

Synopsis

§ 15.01.	Introduction.....	503
§ 15.02.	Recent Securities Exchange Commission (SEC) Activities.....	505
§ 15.03.	Applicability to Energy Development Programs	507
	[1] – Definition of a Security	508
	[2] – Use of Partnerships or Other Entities as Investment Vehicles	508
§ 15.04.	Impact of Being Deemed a Security	509
	[1] – Registration.....	509
	[2] – Exemptions from Registration	511
	[a] – General Rules and Integration	511
	[b] – The Three Transactional Exemptions	512
	[3] – Financial Disclosure in More Detail	517
	[4] – Heightened Standard of Fraud	520
§ 15.05.	Conclusion	521

§ 15.01. Introduction.

Throughout the Appalachian Region and the United States, a significant number of energy development programs (*i.e.*, oil and gas drilling programs) are funded with capital provided by private investors outside of the industry. When energy development companies and their principals solicit these investments, they encounter a web of laws and regulations promulgated by the United States Congress, state legislatures, the Securities and Exchange Commission (SEC) and state securities regulators. The purpose of this chapter is to provide legal practitioners with a reference for where those relevant regulations may exist, what, in general, the regulations require and

¹ The author thanks Sharon O. Flanery, Steptoe & Johnson PLLC, Charleston, and James A. Russell, Steptoe & Johnson PLLC, Morgantown, for their contributions to the contents of this chapter.

how we can assist our clients in navigating this web of regulation to ensure that the financial aspect of these programs are set on solid ground.

It is estimated that in 2004 over 1500 oil and conventional natural gas wells were drilled in West Virginia. Approximately 750 of these wells were drilled by independent operators.² Independent operators are characterized as those operators that utilize the capital of others to drill their gas wells. Assuming a price tag of \$400,000/well, those 750 wells represent a capital investment of \$300 million. Most independent operators have a group of investors whose capital is utilized by the independent operator to drill and complete the wells. When the independent operators solicit investment from their typical investors and accept their money, those independent operators become subject to state and federal securities laws. The most important laws and regulations are those contained in and promulgated under the Securities Act of 1933 (“33 Act”),³ and the Securities and Exchange Act of 1934 (“34 Act”).⁴ In addition, those same independent operators become subject to certain provisions and regulations promulgated under state securities laws, also known as Blue Sky Laws.”⁵

The 33 Act was enacted by Congress in response to the events leading up to the Stock Market Crash of 1929. In short, it was put in place to ensure that there is a marketplace for securities, both private and public, in which investors can feel confident that they are making investments that are based on fair and known terms. In recent years the provisions of the 33 Act have taken on new life as scandals such as Enron, WorldCom, and Adelphia have shaken the confidence of investors in the marketplace. While the subject matter of this chapter does not deal with the public market for securities, those events have had a significant impact on the private marketplace due to (1) increase in investor scrutiny of energy development programs; (2) increase in regulation in the forms of the Sarbanes-Oxley Act⁶ and increased

² Interview with Charlie Burd, Executive Director of the Independent Oil and Gas Association of West Virginia, Inc., via telephone (Sept. 28, 2005).

³ 15 U.S.C.A. §§ 77a *et seq.*

⁴ 15 U.S.C.A. §§ 78a *et seq.*

⁵ *E.g.* W. Va. Code §§ 32-3-301 *et seq.* (2005) and Ky. Rev. Stat. Ann §§ 292.340 *et seq.* (Michie 2005).

⁶ 15 U.S.C.A. §§ 7201 *et seq.*

regulatory activity; and (3) increased scrutiny within the marketplace. Accordingly, compliance with applicable securities laws and regulations has taken on more importance.

§ 15.02. Recent Securities Exchange Commission (SEC) Activities.

If anyone has any doubt that the SEC is actively enforcing the securities laws and regulations in the oil and gas arena with special vigor, one need look no further than a few recent enforcement actions highlighted by the SEC.

In 2002, the SEC sought and obtained a preliminary injunction from the United States District Court for the Central District of California in a case where the SEC alleged that a multi-million dollar securities fraud scheme was being run by four individuals involved in the oil and gas production business. In its complaint, the SEC alleged that during the offering sponsored by Shoreline Development Co., Shoreline and its principals made misrepresentations about the performance of Shoreline's wells, a purported business relationship with a field service company, and the use of investor funds. The SEC further alleged that these defendants concealed their misappropriation from investors of more than \$1.2 million to pay for lavish vacations, a wedding and honeymoon, a vacation home, gambling debts, customized motorcycles and other luxury items. While the underlying case is of considerable interest because of the alleged misrepresentations made by Shoreline and its principals, of more interest was the relief granted by the court.⁷ In addition to suing Shoreline and its principals, the SEC also sued and obtained relief against Shoreline's contractors who received over one million dollars from Shoreline. With respect to Shoreline and its principles, the court (1) appointed a permanent receiver over Shoreline; (2) froze the defendants' assets; (3) prohibited the destruction of documents; and (4) ordered accountings. With respect to what the SEC called "relief defendants," the SEC was granted an order preliminarily freezing the assets of relief defendants Epic Consulting Services, Coastal Resources, Inc., Northstar Acquisitions and Holdings, Inc., Shoreline Holdings and Acquisitions, Inc., and Spartan Consulting, Inc., who together received more than \$1.3 million

⁷ The Securities and Exchange Commission, Litigation Release No. 17702, August 28, 2002, <http://www.sec.gov/litigation/litreleases/lr17702.htm>.