

BakerHostetler



Texas Blue Sky and Federal Securities Laws as to Oil & Gas Investments

*(or, "We Are All Securities Lawyers Now," with apologies to Milton Friedman.)*

Jasper Mason

# But I'm an oil & gas lawyer...

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- *Did we rename the section? This is all well and good, but I don't practice securities law.*
  
- Are you sure?

# Justifying the ethics hour

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- “**Legal Ethics**” shall include programs that deal with usages and customs among members of the legal profession, involving their legal and professional duties toward one another, *toward clients*, and toward the courts.
- “**Legal Professional Responsibility**” shall include programs that deal with maintaining the integrity and competence of the Bar so that legal services are delivered with the highest degree of professional conduct.
  - “Legal Ethics and Legal Professional Responsibility” shall include, but not be limited to the accreditation of those topics involving disciplinary rules of professional conduct, rules of disciplinary procedure, and the use and availability of alternative dispute resolution and pro-bono services.
  - “Legal Professional Responsibility” shall also include *training in skills and concepts that promote and/or assist lawyers in the delivery of high quality legal services to clients such as managing risk and grievance/malpractice avoidance*, effective and ethical client and case management, and trust account management.

# Time for a tune up

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- Recent market conditions
  - Sellers (Issuers!) may need an influx of capital.
  - Buyers may believe now is a great time to buy in and ride the commodity price up to a big payday.
    - It's sure to go up...right?
  - The divestiture of “non-core” assets by larger players creates lots of opportunity for more creative entities.

# Time for a tune up

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- Also, it's been a while
  - *Adderley* prompted several articles and presentations in 2006-07.
  - How many active entities did we have before the Eagle Ford growth and Permian resurgence?
    - As of February 27, 2017, there are now 11,312 P-5 records for entities with oil & gas activity or unexpired P-5s with the RRC – *imagine how many non-ops are out there.*

# We are not discussing:

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- Sale of stock
- Debentures
- Limited partnership interests

# We are discussing:

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- Exposure to federal law for issuers
- Exposure to Texas law for issuers
- “Secondary” liability under each, specifically for aiding and abetting.

# What is a security?

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- Securities Act of 1933 § 2(a)(1), 15 U.S.C. § 77b(a)(1) (2012)
  - *The term “security” means any* note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, *fractional undivided interest in oil, gas, or other mineral rights*, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security”, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

# What is a security?

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- Securities Exchange Act of 1934 § 3(a)(10), 15 U.S.C. § 78c(a)(10) (2012)
  - *The term “security” means* any note, stock, treasury stock, security future, security-based swap, bond, debenture, *certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease*, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a “security”; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

# What is a security?

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- Texas Blue Sky Law - TEX. REV. CIV. STAT. ANN. art. 581-4 §A (Vernon 2003).
  - *The term “security” or “securities” shall include any limited partner interest in a limited partnership, share, stock, treasury stock, stock certificate under a voting trust agreement, collateral trust certificate, equipment trust certificate, preorganization certificate or receipt, subscription or reorganization certificate, note, bond, debenture, mortgage certificate or other evidence of indebtedness, any form of commercial paper, certificate in or under a profit sharing or participation agreement, certificate or any instrument representing any interest in or under an oil, gas or mining lease, fee or title, or any certificate or instrument representing or secured by an interest in any or all of the capital, property, assets, profits or earnings of any company, investment contract, or any other instrument commonly known as a security, whether similar to those herein referred to or not. The term applies regardless of whether the “security” or “securities” are evidenced by a written instrument.*

# What is a security?

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- Joint venture interests
  - Under Texas law, joint ventures are “special purpose” general partnerships
    - Tex. Rev. Civ. Stat. Ann. Art. 6132b-2.02(a) (Vernon Supp. 1997).
  - Whether JV interest classified as security
    - content of agreement
    - whether interest is classified as an “investment contract.”
      - Four factor test under *Howey*, 328 U.S. 293 (1946)
        - Investment of money
        - Common enterprise
        - Expectation of profit
        - Profits derived “solely” from effort of others

# What is a security?

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- Capital calls under some circumstances
  - *Goodman v. Epskin*, 582 F.2d 388 (7<sup>th</sup> Cir. 1978)
    - The Seventh Circuit held that the trial court’s jury instruction that “each subsequent capital contribution...does *not* constitute a purchase of a security” was an incorrect statement of law that constituted reversible error.

# Hypothetical Deal

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- Your client is seeking to reduce exposure to exploration risk and development costs.
- Your client decides to sell some working interest in the project to a few interested friends at the Petroleum Club, and retain a majority and operatorship.
  - Stop me if you've heard this one:
    - *“Just draft me up a quick assignment, Counsel. This is a friendly deal; nothing complicated. Let's keep legal costs down.”*

# Hypothetical Deal

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- Does your client know he/she is an issuer of a security?
  - Texas and Federal definitions above would each apply.

# Federal Securities Law

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- The '33 Act regulates the sale of securities in two ways:
  - Requires the sale of securities be registered, or that the issuer falls under an exemption to the registration requirement
  - Prohibits issuer from misstating material fact (or failing to state material facts) in the sale of securities.

# Federal Securities Law

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- What are the exemptions?
  - Not all who sell securities are required to register - but
  - Anti-fraud provisions still apply
- Who needs (or doesn't need) to register?
  - Intrastate Offering Exemption
  - Private Offering Exemption
- In each situation, burden of proof rests on issuer.

# Federal Securities Law

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- Accredited investors
- Sometimes also unaccredited investors
  - Seller can cure a breach if he reasonably believes that such an investor has experience in business matters which allows him to evaluate the merits and risks of the investment.

# Federal Securities Law

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- Also deemed not a public offering if, in addition to not being made by any general solicitation:
  - Is made only to those persons the issuer reasonably believes can bear the risk, or have the knowledge and experience to enable them to evaluate the merits of the issue, or:
  - Is made only to those persons who have access to the same kind of information that would ordinarily be contained in a registration statement.

# Federal Securities Law

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- What are the remedies?
  - For either a violation of the registration requirement (if not exempted) or the anti-fraud provision, remedy is rescission
    - Price paid for security, plus interest from date of investment, less any distributions received.

# Federal vs. State “Entire lease”

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- You will sometimes overhear the assertion that if a seller is selling the entire interest, the federal law will not apply. This simply isn't true.
  - Investment Contracts
- Texas law generally does not exclude sales of entire interest.

# Texas Securities Act

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- For the sake of consistency, let's address an unregistered security under Texas Blue Sky Law.
  - Exemption from registration under the Texas securities act Section 5(Q) exempts sale of oil, gas or mineral leases if issuer sold to a total number of no more than 35 sophisticated and well-informed investors within 12 months
    - Again, seller must believe that the investors are sophisticated and reasonably well-informed.

# Texas Securities Act

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- Note also Section 109.14(d)
  - Provides an exemption for any offer or sale of any interest in oil, gas or mining lease, or title or payments out of production in or under such leases so long as such offers or sales are made to persons who are involved in the oil and gas industry.

# Texas Securities Act

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- More interesting is the liability for untrue statements or omissions
  - Even if the securities are exempt from registration under the Texas Securities Act, the issuer still must be wary of the anti-fraud provisions.
    - Seller must not offer or sell a security by means of an untrue statement of *material* fact (or an omission of material fact which is necessary in order to make the statement not misleading).

# Which is tougher to defend? (or more favorable to plaintiff?)

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- Once again, it's much more entertaining to talk about the securities which are exempt from registration.
- The '34 Act Rule 10b-5 claim requires proof of scienter and reliance.

# Which is tougher to defend? (or more favorable to plaintiff?)

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- The Texas Securities Act applies the same, easier, standard of proof to all purchases and sales of securities that the '34 act limits to registered securities.
  - TSA does not require proof of scienter or reliance, both of which are elements of the Federal 10b-5 claim.

# Aiding & abetting liability

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- Under the TSA, a person can be secondarily liable to a purchaser if he aided or abetted the issuer.
  - Aider - “A person who directly or indirectly with intent to deceive or defraud or with *reckless disregard for the truth or the law* materially aids a seller, buyer, or issuer of a security.”

# *Sterling Trust Co. v. Adderley* 168 S.W.3d 835 (Tex. 2005)

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- Texas Supreme Court declined to implement a low standard of scienter for aiding and abetting.
  - If Issuer/Defendant, perhaps you can take this as a signal that Texas doesn't want a chilling effect on cooperation/alienation of interest (to promote development).
    - Consistent, no?

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