Oil and Gas, Natural Resources, and Energy Journal

Volume 3 | Number 6

March 2018

The Death of the Joint Venture Exemption in Oil and Gas Securities Regulation

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Oil and Gas, Natural Resources, and Energy Journal

VOLUME 3 NUMBER 6

THE DEATH OF THE JOINT VENTURE EXEMPTION IN OIL AND GAS SECURITIES REGULATION

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I. Introduction

The government has an extremely strong interest in protecting the market integrity for nationally traded securities. Events in American history, such as the Great Depression and the collapse in stock prices that preceded it, have shown what economic turmoil can result from relaxed regulation. In response, the United States federal government and almost all states have enacted securities or "blue-sky" legislation that impose civil and/or criminal penalties for failure to comply with statutory requirements.[1] These laws include the Securities Exchange Act of 1934, the Securities Act of 1933, and other federal and state legislation.

Following the stock market crash which preceded the Great Depression, Congress recognized that the public had little to no confidence in the securities market. In order to reestablish public confidence, and with the ultimate goal of recovering the economy, Congress took action.[2] Congress enacted the Securities Act as a response to these largely unregulated investment markets where serious abuses occurred. As part of that same effort, Congress enacted the Securities Exchange Act a year later in 1934. This act established the Securities and Exchange Commission ("SEC"). The

1. Jonathan Macey & Geoffrey Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347, 348 (1991).

2. The importance of a fair and trustworthy market cannot be overstated. As SEC Chairman William Casey once said, "we must never forget that we are dealing with a priceless asset, the repository of the retirement hopes and educational aspirations of millions of Americans, a unique barometer of our economic health and engine of our economic progress. What does it take for our markets to achieve these great purposes. The markets themselves must have characteristics of liquidity and sensitivity to economic reality. They must be honest and fair and orderly. The public must have confidence that those characteristics prevail. Broad public participation is essential to liquidity. Full disclosure is essential to public confidence."

SEC holds the primary responsibilities of enforcing federal securities laws, recommending securities rules, and regulating the securities industry.[3]

The purpose of both acts was to regulate investments in whatever form they came in, regardless of the name brokers attached to the instruments.[4] To achieve that goal, Congress painted with a broad brush when defining "security" recognizing the endless scope of potential investment schemes that individuals could develop in the future.[5] This sweeping definition has allowed the SEC to pursue charges against investment interests that fall outside of the typically thought of stock certificate.

One of the most central elements of compliance with securities laws includes the registration of investment scheme managers as brokers with the relevant agency. Agencies, such as the SEC, require registration of certain individuals to ensure that they are fully complying with securities law. Registration better enables the SEC to monitor both brokers and dealers of securities, thereby protecting the everyday purchaser of stock. While federal securities law requires registration for many individuals engaged in the process of selling investment interests, these pieces of legislation often are subject to exemptions that serve as a defense for failure to comply with statutory requirements. While some of these exemptions are statutorily-based, others arise out of common law. One common exemption to registration is the formation of an investment operation as a joint venture or general partnership.[6]

This article focuses on federal securities regulation, including compliance with the SEC under the Securities Act and the Securities Exchange Act. More specifically, this paper endeavors to cover whether an oil and gas investment operation that claims to be a joint venture can still be exempt from registration with the SEC in the face of recent case law. Attorneys and market participants alike are often surprised to find out that many oil and gas interests are actually securities. As a result, securities laws can ensnare investment promoters in litigation battles with the SEC or state agencies. The business of oil and gas investments is a unique enterprise. The process of funding, placing, and drilling a well followed by the production of minerals is no simple task. The complicated oil and gas

3. U.S. SECURITIES AND EXCHANGE COMMISSION: "WHAT WE DO," https://www.sec.gov/Article/whatwedo.html (last visited Oct. 24, 2017).

4. Reves v. Ernst & Young, 494 U.S. 56, 58-59 (1990).

5. SEC v. W.J. Howey Co., 328 U.S. 293, 299 (1946).

6. The terms "joint venture" and "general partnership" are interchangeable and describe the organization of a business venture where an undertaking between two individuals or companies occurs for the purpose of carrying out a particular project.

development process has developed into a specialized industry. Further, with the needs for energy production only increasing year by year, this massive industry is here to stay. Expectedly, as with many investment operations, the SEC has kept a close eye on these schemes in order to protect the everyday investor.[7]

In the oil and gas industry, courts have applied the definition of a security in broad terms, to include virtually every type of oil and gas investment that can be created.[8] Therefore, exemptions are often an important mechanism used by investment managers to avoid registration with the relevant governing agency. In *SEC v. Kinlaw Secs.*, the Commission sought to charge Kinlaw for offering oil and gas securities without registering with the SEC.[9] Kinlaw argued that the organization was a general partnership, and thus exempt from registering their managing venturers as brokers.[10] The court allowed Kinlaw to use the general partnership exemption, holding that the SEC failed to meet its heavy burden of establishing that the joint venture interests were in fact securities.[11] In the after math of this case, many oil and gas promoters tried to use their apparent status as a general partnership as a defense.[12] This practice has led to the SEC pounding smaller security operations into compliance with mounds of litigation.[13]

This paper pursues the objective of informing both oil and gas investment operators, as well as the attorneys representing these parties,

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7. James Osborne, *Investment Fraud is Booming Along with Oil and Gas Drilling, SEC Says*, DALLAS NEWS (Jan. 2014), https://www.dallasnews.com/business/energy/2014/01/04/investment-fraud-is-booming-along-with-oil-and-gas-drilling-sec-says.

8. SEC v. Arcturus Corp., 171 F. Supp. 3d 512, 521 (N.D. Tex. 2016).

9. 254 F.3d 1080 (5th Cir. 2001).

10. *Id.*

11. *Id.*

12. The promoters charged in the Kinlaw case later shut down their Texas investments that the litigation was centered on and moved to Colorado. There, the promoters started a new development company known as HEI Resources, or Heartland Energy. The company and its promoters are currently involved in state securities litigation surrounding oil and gas operations. The state has alleged that the promoters have lost over $68 million dollars in investment funds following practices of offering high commissions and targeting drilling areas known to be dry. *See* Aldo Svaldi, *Colorado Began Investigating HEI Resources for Securities Violation in 2002. It Just Scored a Major Victory in the Case*, THE DENVER POST (Jan. 2018), https://www.denverpost.com/2018/01/17/hei-resources-colorado-oil-gas-securities-violations.

13. SEC v. Mieka Energy Corp., 259 F. Supp. 3d 556 (E.D. Tex. 2017); *Arcturus*, 171 F. Supp. 3d at 512; SEC v. Sethi Petroleum, LLC, 229 F. Supp. 3d 524 (E.D. Tex. 2017); SEC v. Couch, No. 3:14–CV–1747–D, 2014 WL 7404127 (N.D. Tex. 2014).

about the erosion of the joint venture exemption in the oil and gas investment arena by examining the history of regulation in the field and providing context from new case law. More specifically, Part II of this paper provides background on the history of oil and gas securities and the SEC's regulation of these instruments. Part III offers discussion on the potential liability of an oil and gas operation under current securities law. Part IV examines the use of the joint venture exemption in the oil and gas industry. This section includes how federal courts have determined liability under the *Howey* test and further establishment of the *Williamson* factors applied to the third prong of the *Howey* test. Finally, Part V proposes advice for attorneys on how to handle the recent changes in oil and gas securities law, and how to adequately advise clients on securities issues they may have as they relate to oil and gas.

II. A Background on Oil and Gas Securities Regulation

A. Legislative History

The initial version of the Securities Act of 1933 contained within the definition of a security any "certificate of interest in any oil, gas, or mining lease."[14] As the preliminary bill was passed between the House and Senate, slight variations of the same phrase were used.[15] The House Report on the final bill signed into law defined "security" broadly so as to encompass the many concepts in the market that fall within the ordinary concept of a security.[16] The report further emphasized that "[t]he definition is broad enough to include as securities, for example, certificates of interest in oil, gas, or mining leases or royalties."[17]

The following year, section 2(1) of the Act was amended by the Security Exchange Act of 1934. The modifications deleted the language "certificate of interest in property, tangible and intangible" and an amendment added "certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights."[18] The final definition provided that "[t]he term 'security' means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas,

14. Securities Act of 1933, S. 875, 73d Cong., § 2 (1st Sess. 1933).

15. Peter Reilly & Christopher Heroux, *When Should Interests in Oil and Gas Be Considered Securities?: A Case For the Industry Deal,* 34 S. TEX. L. REV. 37, 42 (1993).

16. H.R. REP. NO. 85, 73d (1933).

17. *Id*.

18. H.R. REP. NO. 9323 (1933).

or other mineral royalty or lease. . ."[19] The conference report further stated that the purpose of the amendment was to make clear that "certificate[s] of deposit, fractional oil royalty, or leasehold interests and interests of a similar character are included within the definition of a security and thus subject to the Securities Act."[20]

B. The Role of Texas Federal Courts

The state of Texas has produced some of the most influential oil and gas case law in the United States. Texas's history as a leader in oil and gas has given Texas courts the opportunity to shape the field of law governing the industry. Whereas Texas courts produce a lot of case law concerning the practice of oil and gas generally, the federal district courts have been extremely influential on oil and securities law nationally. Much of the case law discussed in this comment concerns litigation that has occurred in either Texas federal district courts or the Fifth Circuit. While oil and gas securities litigation is centered in this region, much of the case law has influenced other federal courts in different parts of the country. Just as previous oil and gas cases have served as persuasive sources of law, these oil and gas securities cases discussed are creating a wealth of common law on which many other jurisdictions rely.

C. Federal Courts as an SEC Forum

When seeking to enforce securities regulations, the SEC has two options for initiating the litigation of an enforcement action.[21] The SEC can either bring an action administratively in front of a SEC Administrative Law Judge ("ALJ") or in a federal district court.[22] This comment delves into the case law created by the SEC's litigation of illegal investment activities in federal courts. When a case requires emergency attention, the SEC will generally file cases in federal court instead of through an administrative proceeding. Emergency relief, such as asset freezes or temporary restrictions in general orders, can only be granted by a federal court and not by an ALJ.[23] Whereas litigation can move relatively quickly, administrative proceedings are infamous for their slowness in processing claims. Another reason the SEC chooses to litigate in federal courts is that the agency views

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19. 1934 Act, 15 U.S.C. § 78c(a)(10) (1988).
20. H.R. REP. NO. 1838 (1934) (Conf. Rep.).
21. Clifford Alexander and Arthur Delibert, *Litigating With the SEC: Choice of Forum*, MONEY MANAGER'S COMPLIANCE GUIDE, ¶ 1030 (2015).
22. *Id*.
23. *Id.*

a federal court injunction as more significant than an administrative cease-and-desist order granted by an ALJ. The reason for this distinction is that an injunction, once violated, is enforceable by an action made for contempt of court.[24] Thus, violators can be subject to strict sanctions, including prison time. In contrast, an administrative order requires a federal court order to enforce it in the case of a breach.

Another reason the SEC files certain cases in federal court is that the discovery rights available to the agency are more extensive than the research opportunities available in an administrative proceeding.[25] These extensive discovery rights allow the SEC to uncover more details about the inter-workings of investment schemes. With more discovery rights, the SEC has been able to shape case law in securities regulation, specifically as applied to quasi-joint ventures in the oil and gas industry. These extensive discovery rights are the reason the SEC has been able to not only push the production of case law concerning the joint venture in oil and gas investments, but also why they are able to keep winning cases. Detailed discovery has allowed the SEC to carve out a number of factors that the Commission believes are the mark of an operation that does not qualify as a joint venture. As is explained later, the SEC has been able to scrutinize agreements of particular importance to the oil and gas industry, such as joint venture agreements and private placement memorandums.

D. Oil and Gas Interests as Securities

There are two means of analysis by which an oil and gas interest can be defined a security under federal law. First, an oil and gas interest might be considered security under the portion of the law that expressly defines certain oil, gas, and other mineral interests as securities.[26] Alternatively, an oil and gas interest might be considered a security due to its status as an investment contract.[27] While this comment focuses on the latter classification of oil and gas interests, it is important to note that the SEC has other avenues that it can use to attack an investment operation.

As to the first option, the Securities Act includes any "fractional undivided interest in oil, gas, or other mineral rights" in the definition of a security.[28] Further, the Exchange Act includes "participation in . . . any oil,

24. *Id.*
25. *Id.*
26. Nelson S. Ebaugh, *Remedies for Defrauded Purchasers of Oil and Gas Interests Under the Securities Laws,* 1 TEX. J. OIL GAS & ENERGY L. 51, 53 (2006).
27. *Id*.
28. 15 U.S.C. § 78c(a)(10) (2006).

gas, or other mineral royalty or lease" in the definition of a security.[29] While these definitions differ slightly, courts have harmonized these two acts by mostly ignoring the Exchange Act definition.[30] The outcome has been that an oil and gas interest is a security if it is a fractional undivided interest in an oil or gas mineral right.[31]

Case law provides that courts should first determine whether an oil and gas interest is a fractional undivided interest in oil and gas.[32] If an interest does not fit within this definition, the court then may determine if the interest is considered an "investment contract" covered by securities laws.[33]

III. Liability of Oil and Gas Investment Operations

This comment will discuss the liability of oil and gas investment operations that seek to identify as general partnerships or joint ventures, and thus do not register their managing venturers as brokers with the SEC. There are only two types of securities: those that require registration and those that are exempt from registration. This idea illustrates that an instrument that is a security must be registered in accordance with security laws unless it has exempt status.[34]

While oil and gas securities fraud has been around as long as the industry itself, recent booms in the industry caused proliferation of the number of securities fraud cases. The SEC has brought an increasing amount of cases each year against fraudulent investment operations. The SEC generally does not have jurisdiction over investment operations that function as joint ventures.[35] The agency lacks jurisdiction because courts consider the investors in these operations to be more similar to partners than merely blind participants.[36] However, the SEC has recently charged several oil and gas investment operations with setting up illusory joint ventures that, in reality, function as a typical investment operations.[37] In these misleading "joint venture" operations, the securities promoter will get most of the

29. *Id*.
30. Reilly & Heroux, *supra* note 15, at 46.
31. Adena Exploration, Inc. v. Sylvan, 860 F.2d 1242, 1252-53 (5th Cir. 1988); Nor-Tex, Agencies, Inc. v. Jones, 482 F.2d 1093, 1097-98 (5th Cir. 1973).
32. *Reves*, 494 U.S. at 61; Landreth Timber Co. v. Landreth, 471 U.S. 681, 686 (1985).
33. *Id.*
34. Ebaugh*, supra* note 26, at 53.
35. Williamson v. Tucker, 645 F.2d 404, 421 (5th Cir. 1981).
36. *Id*.
37. *Arcturus,* 171 F. Supp. 3d at 520; *Sethi*, 229 F. Supp. 3d at 530.

money invested and is not incentivized to further investor prospects because they receive payment whether or not a well pays out. These cases illustrate a reoccurring theme of investment operators seeking to classify their operations as exempt from registration, when in fact registration is required.

The distinction between a partner, someone participating in a joint venture, and a shareholder, a less sophisticated investor, is significant for an investment company. The process of registering a security with the SEC is a costly and often rigorous activity.[38] Further, the penalties for breaching anti-fraud laws are far more stringent for investments that the SEC deems are securities.[39] Therefore, oil and gas promoters may seek to avoid registration with the SEC by structuring an investment scheme as a joint venture.

IV. The Use of the Joint Venture Exemption in Oil and Gas

A. Liability Under the Howey *Test*

The Securities Act intentionally gives a broad definition of the term security, so as to ensure that any instrument that might be sold as an investment is covered.[40] The definition is sufficiently broad enough to encompass almost any instrument that may be sold or purchased as an investment.[41] The Securities Act of 1933 includes in the definition of a security any "fractional undivided interest in oil, gas, or other mineral rights."[42] The Securities Exchange Act of 1934 includes in its definition "participation in . . . any oil, gas, or other mineral royalty or lease."[43] While these two definitions differ slightly in their classification of oil and gas interest; courts have interpreted the two in accord to mean the same thing.[44] These definitions also include the term 'investment contract', but it is not defined by either the Securities nor the Exchange Act. In *SEC v. W.J. Howey Co.*, the Supreme Court defined an investment contract as "a contract, transaction or scheme whereby a person invests his money in a

38. Alexander & Delibert, *supra* note 21, at ¶ 210.
39. *Id.*
40. *Reves*, 494 U.S. at 61.
41. *Howey*, 328 U.S. at 293.
42. Securities Act of 1933, 15 U.S.C. § 77b(a)(1) (2006).
43. Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10) (2006).
44. *Landreth*, 471 U.S. at 686.

common enterprise and is led to expect profits solely from the efforts of a promoter or a third party."[45]

The *Howey* analysis provides a three-prong test for determining whether an investment scheme is an "investment contract." The test requires that there be "(1) an investment of money; (2) in a common enterprise; and (3) on an expectation of profits to be derived solely from the efforts of individuals other than the investor."[46] The first two factors which consider whether there is an investment in a common enterprise are almost always met in the cases that raise issue before the courts. Therefore, the analysis in each case often comes down to the third and final factor concerning the expectation of profits.

The Fifth Circuit held in *Williamson v. Tucker* that the term "solely" is to be interpreted in a flexible, rather than a literal, manner.[47] In determining whether parties expect profits to come "solely" from the efforts of others, the Fifth Circuit adopted the Ninth Circuit's test, which asks whether the efforts made by individuals other than the investor are the significant ones which affect the success or failure of the enterprise.[48] The *Williamson* case further provides that the third *Howey* factor is established if the partnership can be characterized by partners that that are "so dependent on a particular manager that they cannot replace him or otherwise exercise ultimate control."[49] Following the *Williamson* case, courts consider three factors when determining whether the partners are so dependent on the efforts of another that the scheme is actually an investment contract:

> (1) An agreement among the parties leaves so little power in the hands of the partner or venture that the arrangement in fact distributes power as would a limited partnership; or
>
> (2) The partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or

45. 328 U.S. at 298-99; *see also* United Hous. Found. v. Forman, 421 U.S. 837, 852 ("The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.")

46. *Id.*

47. 643 F.2d at 417.

48. SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 483 (5th Cir. 1974) (citing SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 482 (9th Cir. 1973)).

49. *Williamson,* 643 F.2d at 424.

> (3) The partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.[50]

The court considers the factors nonexclusively when determining whether joint venturers participating in an investment are so dependent on another party's effort that the investment is actually an investment contract.[51]

B. The Joint Venture/General Partnership Exemption

A joint venture can generally be described as "an association of persons, created by express or implied agreement, who combine their property, knowledge, and efforts to carry out a single business venture for the purpose of realizing a profit."[52] Courts have held that joint ventures, once established, continue until there is evidence of termination by the venturing parties.[53] The main difference between a joint venture and a regular partnership is the limited scope and duration of a joint venture.

Another important component of a joint venture is that each member owes a fiduciary duty to each of the other members of that joint venture.[54] Thus, in a true joint venture one member may become liable to another member for property of the venture that has been apportioned for his use.[55] This level of liability is not what investors are usually expecting to take on when they participate in an oil and gas drilling operation. Therefore, few true joint ventures exist in the world of oil and gas investments.

Typically, a general partnership or joint venture interest is not included in the definition of an investment contract.[56] However, simply labeling an investment as a general partnership will not prevent a finding that the instrument falls within the jurisdiction of federal securities laws.[57] Further, the *Williamson* case defines the type of evidence courts should consider when determining the expectations of control as they relate to an operation's status as a joint venture.[58] *Williamson* directs court to rely on

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50. *Id*.
51. *Id*.
52. NANCY SAINT-PAUL, SUMMERS OIL AND GAS § 47.3 (3d 2017).
53. Lyle Cashion Co. v. McKendrick, 204 F.2d 609 (5th Cir. 1953); Donnelly v. Guthrie, 194 F.2d 164 (5th Cir. 1952).
54. De Witt v. Sorenson, 288 F.2d 455, 459-61 (5th Cir. 1961).
55. *Id.*
56. *Williamson*, 645 F.2d at 419-21.
57. *Forman*, 421 U.S. at 848-49.
58. *Williamson*, 645 F.2d at 756-57.

the totality of the circumstances surrounding an offer for an investment in making a determination of the classification of an investment operation.[59] In other words, courts evaluate whether an interest is a security based on the economic reality underlying a transaction, and not merely the name attached thereto.[60]

When focusing on substance rather than form, the courts looks at representations made by a promoter in marketing an interest and not just the legal contracts that underlie the sale of the venture.[61] Additionally, the court considers investment conduct as relevant to determining the intent of the parties at the time the agreement was signed.[62] Further, the acts of the involved parties even after the signature of agreements are also relevant to a determination of the intent of the parties.[63] The later participation, or lack thereof, of investors sheds light on how the parties regarded their rights and status under an agreement at its inception.[64]

In *Youmans v. Simon*, the Fifth Circuit stated that there remains a "strong presumption that a general partnership or joint venture interest is not a security."[65] The *Youmans* court further pushed that "[a] party seeking to prove the contrary must bear a heavy burden of proof."[66] Therefore, district courts generally examine each of the *Williamson* factors to determine if the SEC has met the heavy burden of establishing that the interest sold by a defendant was a security.[67]

While this article seeks to shed light on the disappearance of the joint venture exemption in the regulation of oil and gas investment operations, there are examples of less commonly used investment models that may qualify as joint ventures. For example, an agreement amongst adjoining landowners for the recovery of hydrocarbons establishing a lessee-royalty owner relationship constitutes a joint venture.[68] Similarly, a group acting together to purchase an oil and gas lease that shares in the losses and gains[69]

59. *Id.*
60. *Forman*, 421 U.S. at 848-49.
61. SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 353 (1943).
62. Maritan v. Birmingham Props., 875 F.2d 1451, 1458-59 (1989).
63. *Id*.
64. *Id*.
65. 791 F.2d 341, 346 (5th Cir. 1986).
66. *Id*. (citing *Williamson*, 645 F.2d at 424).
67. *Sethi*, 229 F. Supp. 3d at 533.
68. Carroll v. Caldwell, 147 N.E.2d 69, 75 (Ill. 1957).
69. These oil and gas operations that actually qualify as joint ventures are typically smaller "Mom and Pop" set ups that involve either family members or neighboring landowners joining together to develop smaller tracts of land.

may also constitute a joint venture.[70] However, modern securities regulation of oil and gas investments, more often than not, involve individuals who have not contemplated or exerted action on the management or control of a drilling operation. Thus, these courts are highly unlikely to identify these investors as participants in a joint venture.

C. Establishment of a Joint Venture

Joint ventures have gained popularity in the oil and gas investment sector as a way to structure drilling investment schemes.[71] More investment organizers have opted for the joint venture structure because it combines the benefit of joining funds while also diluting any economic risk to a company.[72] A joint venture merely involves two or more parties that jointly undertake a commercial enterprise, but otherwise maintain their separate identities. When one party wants to start a joint venture, they must solicit support from one or more other parties to participate.[73] In the oil and gas cases discussed in this paper, support is usually curated by both communicating directly with potential investors and the distribution of persuasive documents. This sales package will include information about the prospective drilling project, including: geological information related to the project, data on wells from the surrounding areas, potential production amounts, estimated costs of drilling and completing a well, and information on how the operator acquired the right to drill (lease agreement, forced pooling, etc).[74] The operator typically provides this information through the use of several documents discussed in more detail below. The purpose of the sales package is to give potential investors as much information as is reasonably necessary to allow the parties to make an informed decision about whether or not to invest.[75] This information contained in the sales package may be presented more or less specifically depending on the targeted potential investors experience level with oil and gas projects.

The relationship between investors and an operation is solidified through the signing of a joint venture agreement. A joint venture is based on either

70. Donohoe v. Consol. Operating & Prod. Corp., 982 F.2d 1130, 1135 (7th Cir. 1992).

71. Adi Karev, *Joint Ventures: Outlook Remains Strong Despite Ongoing Cost and Schedule Overruns*, OIL & GAS FINANCIAL JOURNAL (Dec. 15, 2015), http://www.ogfj.com/articles/print/volume-12/issue-12/features/joint-ventures.html.

72. *Id.*

73. *Id.*

74. R.K. Pezold & Danny Richey, *The 'Industry Deal' Among Oil and Gas Companies and the Federal Securities Acts*, 16 TEX. TECH L. REV. 827, 831 (1985).

75. *Id.*

an express or implied agreement.[76] Regardless, the agreement should be in writing and should state the nature of the parties' relationship.[77] Further, the rights, duties, and obligations of all parties involved should be clearly expressed.[78] When an agreement is silent as to certain rights or obligations, those rights of the joint venturers are governed by the rules that apply to general partnerships.[79]

A number of documents are involved in eliciting investor participation in a joint venture, including private placement memoranda ("PPMs"), joint venture agreements ("JVAs"), and confidential information memoranda ("CIMs").[80] Understanding the purposes and use of these documents is important because courts often look to these offering documents as evidence as to the status of an investment operation. PPMs are detailed documents that contain a summary of the investment operations. When involving oil and gas, PPMs often cover a number of topics, such as the terms of the offering, risk factors involved in the investment, investor participation in costs and revenues, management of the operation, and potential conflicts of interest. A JVA typically contains more detailed information about the specific operations of the venture. Examples of topics included in a JVA might include how investor money will be used to further the operation or information on daily operations. A CIM also provides information on the operation of the venture but may also provide confidential details that the venture organizers do not want the general public to know about.

D. Penalties for Failure to Comply with Federal Securities Regulations

The inquiry into whether an oil and gas interest is a security is important because it is the question upon which civil and criminal liability hinges. The unauthorized sale of securities is a violation of Sections 5(a) and 5(c) of the Securities Act.[81] Section 5(a) makes it unlawful to use the U.S. mail to transport "any such security for the purpose of sale or for delivery after sale."[82] Section 5(c) states that it is unlawful for any individual to utilize "interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a

76. 11 Texas Forms Legal & Bus. § 22:23.
77. *Id.*
78. *Id.*
79. *Id.*
80. *Arcturus*, 171 F. Supp. 3d at 520.
81. 15 U.S.C. §§ 77(a)–77(aa).
82. *Id.*

registration statement has been filed as to such security . . . ."[83] To establish a prima facie case for 5(a) and 5(c) violations, the SEC must prove: (1) defendants offered or sold securities; (2) the securities were not registered as required by Section 5; and (3) defendants used the United States mail or interstate commerce to offer or sell the securities.[84] Once the SEC has satisfied its burden, the defendant then bears the burden of proving that he or she qualifies for an exemption from the registration requirement.[85]

Further, Section 15(a) of the Exchange Act makes it unlawful for a broker who is not registered to use the U.S. mail or interstate commerce to induce the sale of a security. The act defines a broker as "any person engaged in the business of effecting transactions in securities for the account of others."[86] The SEC asserted that hiring sales agents to contact potential investors and compensating them with transaction-based earnings is an example of acting as a broker.[87] The Act does not define the term "engaged in business," but courts have defined it generally as the act of buying and selling securities.[88] Also, undefined by the Act, the court considers a number of factors when determining if a party was "effecting transactions."[89] These factors include: (1) whether investors were solicited to buy securities; (2) whether the defendant was involved in negotiations between the issuer and the investors; and (3) whether the party received a transaction-related compensation or a salary.[90]

Section 20(e) of the Exchange Act allows the SEC to bring a civil suit against any individual who knowingly or recklessly provides assistance to another person in violation of the statute. This expands the reach of the SEC beyond investment managers to other parties involved in management, such as promoters or organizers.

The SEC has sought a number of penalties in its suits against investment managers, including: (1) prohibiting defendants from acting as a director of any issuer of a class of securities; (2) permanently enjoining defendants from soliciting investors to purchase securities; (3) prohibiting defendant's from participating in any oil and gas related security offering as a manager,

83. *Id*.
84. Dennis v. Gen. Imaging, Inc., 918 F.2d 496, 503-04 (5th Cir. 1990).
85. SEC v. Cont'l Tobacco Co., 463 F.2d 137, 155-56 (5th Cir. 1972).
86. 15 U.S.C. § 78c(a)(4).
87. SEC v. GC Res., LLC, Case No. 3:15-cv-01048-B, 2015 WL 1522331 (N.D. Tex. Apr. 6, 2015) (Trial Pleading).
88. *Id*.
89. *Arcturus*, 171 F. Supp. 3d at 532.
90. *Id*.

administrator, promoter, finder, consultant, agent, or issuer; (4) ordering defendants to pay an amount equal to funds and benefits obtained illegally, plus prejudgment interest on that amount; and (5) ordering defendants to pay additional civil monetary penalties as the court sees fit.[91]

Regarding monetary penalties and fines, Section 20(e) of the Securities Act and Section 21(d)(3) of the Exchange Act authorize courts to assess civil money penalties. Monetary fines are designed to serve as deterrents against future violations, both for the accused and the public. When determining fines, the court considers the following factors: (1) the egregiousness of the defendant's conduct; (2) the degree of scienter on the part of the defendant; (3) whether the defendant's conduct created substantial losses or the risk of substantial losses to other parties; (4) whether the defendant's conduct was isolated or recurrent; and (5) whether the penalty should be reduced due to the defendant's demonstrated current and future financial condition.[92]

The SEC retains broad authority to seek injunctive relief, such as the suspension of investment operations of a company. Congress enacted the Investment Advisers Act to monitor and regulate the activities of individuals who participate in the sale of securities.[93] The Investment Adviser's Act permits the SEC to bring civil injunctive actions in federal district courts to seek relief against any individual who has violated or is about to violate the Act.[94] In determining whether to grant injunctive relief, courts have looked at whether the relief was necessary to prevent future violations. Courts have inquired into a variety of factors, including whether the violation was an isolated incident, what degree of scienter was involved, whether the defendant shows remorse for their actions, and whether the defendant's occupation places him in a position where he could commit future violations.

E. Application of the Howey *Test and* Williamson *Factors to Oil & Gas*

Courts have applied the *Howey* test to oil and gas investment operations to determine if an investment scheme is a true joint venture or not. The third prong of the *Howey* test is supplemented by the three factors from *Williamson* to determine if there was an expectation that profits would be

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91. SEC v. GC Res., LLC, Case No. 3:15-cv-01048-B, 2015 WL 1522331 (N.D. Tex. Apr. 6, 2015) (Trial Pleading).

92. SEC v. Offill, No. 3:07–CV–1643–D, 2012 WL 1138622, at *3 (N.D. Tex. Apr. 5, 2012).

93. 15 U.S.C. §§ 80(b)(1)–(21).

94. *Id.*

obtained from the efforts of individuals other than the investor.[95] As the analysis below shows, there are certain aspects unique to the oil and gas business that make it nearly impossible for operators within the drilling industry to sustain joint ventures.

1. Williamson *Factor 1: Lack of power in the hands of venturers*

The first *Williamson* factor concerns the question of whether there is an agreement among the parties that leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership.[96] To determine the extent of the venturers' power, courts look at post-investment activities.[97] Court's examine these post-investment activities because focusing on merely the terms of the partnership agreement would conflict with the substance over form rule from *Howey*.[98] This conflict would be an "invitation to artful manipulation of business forms to avoid investment contract status."[99]

The courts have refused to accept merely power for venturers on paper, without further proof, as evidence of ample venturer control to qualify as an investment contract.[100] Under the general canons of construction, courts give effect to the manifested intent expressed in a contract purporting to create a joint venture.[101] However, if the circumstances dictate that the arrangement between the parties creates a status different from the language in the contract, the court will not allow the parties' designation to control.[102]

In *SEC v. Arcturus Corp.*, the SEC filed a civil enforcement action alleging that two Texas corporations had offered and sold interests in oil and gas drilling projects called joint ventures, rather than security interests, in an attempt to avoid the regulation of the SEC.[103] Each of these oil and gas offerings had a JVA that provided details on the structure of the venture and the delegation of powers and duties.[104] The JVA granted venturers voting rights as well as the ability to call a meeting.[105] These voting rights included the ability to remove the managing venturer and amend the terms

95. *Williamson*, 645 F.2d at 417-18.
96. *Id*. at 401.
97. *Id*.
98. SEC v. Merch. Capital, LLC, 483 F.3d 747, 760 (11th Cir. 2007).
99. *Id*. (citing *Williamson* 645 F.2d at 418).
100. SEC v. Shields, 744 F.3d 633, 643 (10th Cir. 2014).
101. FRANCIS M. DOUGHERTY ET AL., 55A TEX. JUR., OIL AND GAS § 557 (3d ed. 2018).
102. *Id*.
103. 171 F. Supp. 3d 512, 534 (N.D. Tex. 2016).
104. *Id*.
105. *Id*.

of the original JVA.[106] The court, however, declined to accept the JVA as evidence that the venturers had any actual power.[107] While the agreement may have vested certain voting powers in the ventures, its voting requirements undid that conferring of rights. The JVA required a 60% interest vote in order to remove the managing venturer of the operation.[108] While 60% may seem like a fair amount on paper, logistically this threshold proved nearly impossible to meet because of the inability of investors to contact one another. As was the case in *Arcturus*, oil and gas investment schemes often involve investors that are scattered across the country.[109] It is hard for oil and gas operations to defend against the first *Williamson* factor because of the logistics of the business involving investors that are spread across the country. Oil and gas investors are often scattered across the country because projects tend to be concentrated in certain geographical areas. It can be difficult for these investors to arrange to meet and discuss the management of the operation.

In addition to investors being scattered across the country, communication is also difficult because of the lack of access investors have to information about co-venturers. Investors may have the power to organize and vote on paper, but they may not actually be able to do so in practice if they do not have the ability to contact other investors. Investment schemes may choose to restrict access to the organization's books or records for a number of reasons. This concealment of information leads to venturers' inability to contact one another so that they may exercise their powers as investors. For example, in *SEC v. Sethi Petroleum*, the company charged with selling securities had solicited investors from across the United States with no prior relationship to one another, and did not provide the investors with access to records about one another.[110] The court allowed these facts to establish that the investors had no ability to exercise the powers they had been proscribed on paper because they had no information about other investors that could be used to contact others.[111] *Sethi* shows that a court will not allow mere powers on paper to serve as evidence that the first *Williamson* factor is inapplicable. Instead, investors must have a means by which to remain in contact with another.

106. *Id.*
107. *Id.* at 525.
108. *Id.*
109. *Id.*
110. *Sethi*, 229 F. Supp. 3d at 530.
111. *Id.* at 534.

The exact level of involvement needed by investors to ensure an operation's status as a joint venture is a gray area. While investors, need real power to exert control of an operation, it is hard to state how much control is necessary to meet that threshold. In *SEC v. Couch*, the court was displeased with the fact that the defendants did not transfer title to interest in any of the wells to the investors.[112] The SEC has gone as far as to insinuate that investors in a joint venture should have input on which wells are drilled or regarding if a wildcat well[113] should be drilled on a particular tract at all.[114] Further, the SEC has suggested investors should have input on how operators spend and allocate investment proceeds.[115] This level of input could require investment operators to consult investors at almost every part of the drilling process. While this input would give investors control and purport to create a joint venture, that level of participation is almost always disadvantageous to all parties because of the investor's lack of knowledge and the need for an operation to have consolidated management.

2. Williamson *Factor 2: Inexperience and lack of knowledge of venturers*

The second *Williamson* factor considers the question of whether the partner or venturer is so inexperienced and unknowledgeable in business affairs that they are incapable of intelligently exercising their partnership or venture powers.[116] This factor is also nearly impossible to defend against for oil and gas operations. In order to determine if this factor is established, Courts look to whether the investors were knowledgeable and experienced in the particular industry the venture involved.[117] This test derives from the Fifth Circuit's decision in *Long v. Shultz Cattle*.[118] In *Shultz*, the court

112. *Couch*, 2014 WL 7404127 at *8.

113. A wild cat well is a well drilled in area that is not previously known to be an oil field. The fugacious nature of oil and gas often requires that wells are drilled in areas where it is not known if any oil can be produced. This risky practice only adds to the notion that oil and gas is a highly specialized and unique area of business.

114. SEC v. Petroforce Energy, LLC, No. 1:17-cv-00698, 2017 WL 3139977 (W.D. Tex. July 24, 2017) (Trial Pleading).

115. *Id.*

116. *Williamson*, 645 F.2d at 423-24.

117. Long v. Shultz Cattle Co., Inc., 881 F.2d 129, 134-35 (5th Cir. 1989).

118. In addition to offering clarification on the application of the second *Williamson* factor concerning the experience of venturers, *Long* also provides insight into one of the general themes perpetuated by the SEC in its lawsuits. *Long* again shows the idea that the courts are not concerned with the appearance of an instrument when determining whether or

looked at whether cattle-feeding consulting agreements were unregistered securities.[119] The Fifth Circuit refused to weigh heavily the fact that investors in the case were experienced and successful business venturers. Instead, the court focused on whether the investors had specific experience in the cattle business.[120]

Shultz shows that courts must consider the specific nature of the business the securities are sold within. The inquiry of the court is whether the investors are so unknowledgeable and inexperienced in a particular area of business that it is more likely they would "be relying solely on the efforts of the promoter to obtain their profits."[121] Courts have often held oil and gas investment schemes to an even higher standard, requiring not only that investors are experienced in oil and gas, but that they have drilling-specific experience.[122] Just as general business knowledge is not enough to qualify an investor as informed, it follows that general oil and gas knowledge might not be sufficient satisfy the informed standard set by *Williamson*. Oil and gas is a highly specialized field that most individuals are not familiar with, especially the unique components of drilling. Most individuals looking for operations to invest in do not have any oil and gas experience or knowledge about the field. Therefore, it can be difficult for a group of investors to all be both knowledgeable and experienced enough to defeat this fact.

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not it is a security. This idea of substance over form is again evidenced by the fact that the court in *Long* was willing to find that cattle-feeding consulting agreements were unregistered securities. If a court is willing to find that a cattle-feeding agreement is a security, it only follows that many oil and gas interests might be considered securities as well.

119. *Shultz*, 881 F.2d 134-35.

120. *Id*.

121. SEC v. Merch. Capital, LLC, 483 F.3d 747, 762 (11th Cir. 2007).

122. To a lay person, the difference in general oil and gas knowledge and drilling experience may seem like nothing. However, just as the oil and gas industry is highly specialized, so are the subsections of the industry, such as drilling. Oil and gas development is often separated into three sections: upstream, midstream, and downstream. Drilling is included as a part of the upstream process, showing that there are plenty of other areas of oil and gas that an investor might be involved in that are not drilling specific. The process of drilling a well involves a number of steps; a quick summary follows. First, a drill site must be identified, usually through the use of either a geologist or seismic testing. Next, an operator must obtain sufficient investment to fund the drilling project. This step is where investors are contacted and asked to participate in the drilling venture. Once money is obtained and an operator has all of the necessary equipment and personal lined up, drilling usually begins. If oil is obtained, the operator will have to decide how to market the oil. In many cases oil is not obtained, leading to a loss in drilling costs and the need for the well to be sealed.

In addition to investors being knowledgeable, it is also important for investment operators to be experienced in the oil and gas industry. The SEC has been quick to note whether or not the party had oil and gas experience when accusing an individual of acting as an unregistered broker.[123] In especially competitive areas of oil and gas production, the manager's knowledge might require experience in the purported area of development. While no law currently requires investment managers to be experienced to maintain their joint venture status, the SEC seems to increasingly include it as a factor when deciding which investment operations to prosecute for violations.

Courts have been especially reluctant to accept as joint ventures operations where organizer targeted investors using cold calls. Many smaller investments operations solicit participation in oil and gas drilling schemes through use of lead lists. In *Shields*, the Tenth Circuit accepted the marketing of oil and gas interests by use of cold calls as evidence that investors were so inexperienced as to not be able to exercise their venture powers.[124] Courts have continued to hold that when promoters make offers for securities through the use of hundreds of cold calls to investors with little to no oil and gas experience, one can conclude that the investors were so inexperienced to the level that they are incapable of exercising their powers in the venture.[125]

This factor concerning the knowledge and experience of venturers has been important in distinguishing between sophisticated and unsophisticated investors, and its impact has been the source of controversy for decades.[126] There has long been an "industry deal" in the oil and gas business involving the purchase of working interests by sophisticated investors.[127] After testing suitable land for oil development, an operator might prepare a sales package to distribute to companies who have had prior dealings in oil and gas exploration.[128] Once the organization reviews the sales package, the company decides whether to purchase a working interest in the drilling project.[129] These industry partners naturally have a better understanding of the complexities of the oil and gas business. Therefore, lawyers have

123. SEC v. Petroforce Energy, LLC, No. 1:17-cv-00698, 2017 WL 3139977 (W.D. Tex. July 24, 2017) (Trial Pleading).

124. 744 F.3d at 647.

125. *Sethi*, 229 F. Supp. 3d at 536.

126. Pezold & Richey, *supra* note 74, at 828.

127. *Id.* at 831.

128. *Id.*

129. *Id.*

argued that these sophisticated and knowledgeable parties that invest in oil and gas prospects do not need the protection of federal securities laws.[130] However, while these investors may be knowledgeable about investing in drilling operations, investment agreements may still not qualify as joint ventures if the remaining two *Williamson* factors are not met. This idea raises questions of whether an investor deserves protections even in the event of failure of the other factors because of their prior knowledge about the industry. As discussed, the Federal Securities Acts may give rise to a right of recession for an operator's failure to register an offering in a drilling prospect as a security. While historically the oil and gas industry has not viewed these transactions as securities, they likely fall within the definition of a security and may warrant registration with the SEC unless exempt. [131] Thus, the ability of the operators to obtain the status of a joint venture, and thus be exempt from registration, is important to operations involving sophisticated investors as well.

3. Williamson *Factor 3: Venturers' dependence on abilities of defendants*

The third *Williamson* considers the question of whether the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that they cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.[132] Courts have deemed an agreement to be an investment contract if the investors have no practical alternative to the managing venturer or they are unable to completely exercise their powers as venturers.[133] A dependent relationship exists when the investors of an operation rely on the "managing partner's unusual business experience and ability in running that particular business."[134] The *Williamson* court noted that even a knowledgeable partner in an operation may be left without a reasonable alternative when there is not a sound replacement for the manager.[135] The court further reasoned that in these situations a legal right of control has limited value if partners have no choice but to rely on the manger's abilities in order to continue the operations of the venture.[136]

130. *Id.* at 828.
131. *Id*. at 834.
132. *Williamson*, 645 F.2d at 422-23.
133. *Id*.
134. *Id*. at 423.
135. *Id*. at 425.
136. *Id*.; *see also Merch. Capital*, 483 F.3d at 763.

The ability to remove a managing venturer is considered one of the hallmarks of a joint venture.[137] Many joint venture agreements vest in the managing venturer complete power over drilling operations. While this may not seem to be in the best interest of the venturers, it may actually be required in order to commence drilling operations. Oil and gas operations often call for power to be centralized in the hands of a single individual.[138] For example, contractors may not want to do business with an enterprise that is frequently changing its head of drilling operations.

Another factor that courts have considered as a sign of venturer dependence on managing directors is when venturers have limited or nonexistent access to funds.[139] In *Arcturus*, the defendant held venturers' money in an account that was controlled exclusively by the defendant managers of the investment operation.[140] Lack of access to accounts limits the ability of venturers to remove the managing venturer. Even if the venturers were able to vote the managing venturers out, they would have no access to funds, and thus the joint venture would be at risk of failing because it would lack assets to fund further drilling.[141] Thus, the lack of access to the funds or assets of an operation creates a picture of venturers' complete dependence on the managing venturer.

In considering the third *Williamson* factor, courts may also contemplate the representations made by promoters or others with the goal of inducing reliance upon their unique abilities as managers.[142] In *Sethi*, the court looked at statements promoters made while contacting potential investors.[143] For example, the cold call regime made promises that the operations would produce over one million barrels of oil a month and that investors would immediately begin receiving revenue checks with return

137. *Arcturus*, 171 F. Supp. 3d at 530.

138. The idea that an oil and gas operation needs to be centralized in the hands of one or two individuals is another idiosyncrasy of the industry. The economic risks associated with drilling often require power to be centralized so that there is a specific party making all of the decisions. These decisions may include: whether to drill, what contractors to hire, when to cease operations, and how to market the hydrocarbons should production be obtained. If too many parties are involved in these decisions, then it could have harmful consequences for the operation.

139. *Arcturus*, 171 F. Supp. 3d at 530.

140. *Id*.

141. *Id*.

142. Gordon v. Terry, 684 F.2d 736, 742 (11th Cir. 1982); *see also* Koch v. Hankins, 928 F.2d 1471, 1478 (9th Cir. 1991).

143. *Sethi*, 229 F. Supp. 3d at 537.

rates at 30-60% per year.[144] Further, in the PPM promoters touted their experience and ability to produce profits in the oil and gas industry.[145] Additionally, the operation peddled its ability to make a profit in the exclusive Bakken Shale market.[146] More specifically, the Executive Summary stated that the Bakken Shale had already been monopolized by major oil and gas companies, and thus the ability of the company to drill in the region would be a unique benefit to investors.[147] Ultimately, the court agreed with the SEC's argument that the company's purported experience in an exclusive market, coupled with the illustrious promises made by promoters showed that the investors were without a reasonable alternative management option.[148] *Sethi* shows that courts will not take lightly the fact that promoters have made illustrious promises, and instead may weigh these statements heavily as evidence that the investors were dependent on the promoters.

Further, the first *Williamson* factor covering lack of power in the hands of the venturers overlaps in concept with the third factor. When investors lack power in an investment operation, it is often due to their dependence on the management of the scheme. In *SEC v. Mieka*, the court accepted the fact that the investors had expressly delegated the management of the operations of the joint venture to the company as evidence that the venturers were dependent on the defendant managers.[149] Similarly, in *Arcturus* the facts of the case showed that the venturers delegated all powers related to the day-to-day management of the venture to the operations manager as a managing venturer.[150] The investors in that case also delegated "the power to act on behalf of, sign or bind the Joint Venture" or other venturers with the managing venturer through the language in the JVA.[151] Further, the agreement in that case vested in the manager "full and plenary power" over drilling operations, and allowed the manager of the operation to either "retain or act as operator(s)" for the purposes of testing, drilling and completing any wells.[152] The court again found that these facts together illustrate that the venturers were dependent

144. *Id.*
145. *Id.*
146. *Id.*
147. *Id.*
148. *Id.* at 538.
149. *Mieka*, 259 F. Supp. 3d at 562-63.
150. *Arcturus*, 171 F. Supp. 3d at 524.
151. *Id.*
152. *Id.*

on the managing venturer because he controlled all aspects of the drilling operations, ultimately leaving investors powerless.[153] This hesitation to allow a managing venturer to control drilling operations further shows how difficult it is for oil and gas operations to defend against this factor. If a central party is not allowed to have general power over drilling, it may be hard for the operation to have direction. Without a coherent direction, it may be hard for an operation to be successful.

F. State Security Acts

While this comment focuses on federal security provisions, it is important to note that additional registration with a state security agency may be required.[154] In Texas an aggrieved investor may have a claim under the Texas Securities Act for the sale of an unregistered security.[155] Understanding the implications of state securities laws is important because more oil and gas interests may fall within the definition of a security under a state act than under the federal definition.[156] For instance, the Texas Securities Act includes many oil and gas interests that are explicitly excluded from the definition of a federal security.[157] Additionally, other important litigation factors, such as a statute of limitations, may be different under a state act than under federal law.[158]

V. Looking Forward: The Future of the Joint Venture Exemption

This rapidly emerging case law will likely require the legal community to react to developments in oil and gas securities regulation. Attorneys are at the front line when it comes to advising investment organizers with how to set up and structure their investment operations. A number of factors currently affect an attorney's ability to advise a client coherently on

153. *Id.*

154. Generally, a party who purchases an oil and gas interest might have a cause of action under state and federal securities laws in Texas if they: (1) purchase an oil and gas interest that required registration but was not registered; or (2) are the victim of a misrepresentation by a promoter. When dealing with the first claim, federal and Texas laws address the type of injury similarly. However, when a claim involves misrepresentation or an omission by the oil and gas operation, many parties opt to bring claims under Texas state law instead of federal laws because Texas's Blue Sky laws include more oil and gas interests than federal securities laws. This differentiation shows why it is important for attorneys and clients alike to be informed on securities regulation at both the federal and state level.

155. Tex. Rev. Civ. Stat. Ann. Art. 581-33 (West 2001).

156. Ebaugh, *supra* note 26, at 58.

157. *Id.*

158. *Id.*

whether or not an operator's classification excuses its compliance with certain requirements from regulatory security agencies.

A. Need for Consensus in the Legal Community

There is a clear need for consensus on the question of whether the joint venture exemption is available to oil and gas investment operations. Attorneys who work in the oil and gas securities sector are often charged with advising these oil and gas companies as well as promoters who seek to procure funds from investors. Included in this advisement is usually a suggestion on whether to register with the SEC. Currently, there is disagreement in the legal community as to whether the joint venture exemption is still valid in oil and gas practice. Again, while in theory the courts have upheld this exemptions for a number of industries, the quirks of the oil and gas business have made it seemingly more difficult for the exemption to apply to the industry. This disagreement in the legal community can be harmful to clients because it creates the opportunity for situations to arise that open up investment scheme operators to liability. Therefore, the legal community should come together to agree upon one or more methods of better clarifying what oil and gas investment operations are exempt from registration with the SEC based on joint venture status.

B. The Significance of Kinlaw

The *Kinlaw* case discussed at the beginning of this comment spurred the common use of the joint venture exemption because the court found in favor of unregistered oil and gas investment promoters. While it would seem intuitive that attorneys could lean on this holding to help support their clients, that has not been the case. Defendants have attempted to defend their practice using this case with little luck.[159] For example, in *Arcturus*, defendants wrote in their reply brief in support of their motion for summary judgment that the *Kinlaw* case featured very similar facts and was comparable to theirs.[160] Defendants noted that both cases featured similar JVAs, distribution plans, legal structures, CIMs, questionnaires, and other pertinent facts.[161] The promoters further argued that they had structured their own agreements based on the arrangement that had been approved in Kinlaw.[162] Further, defendants argued that they had imposed requirements on membership in the joint venture that had even exceeded those in

159. Brief for Defendant, SEC v. Arcturus Corp., 171 F. Supp. 3d 512 (N.D. Tex. 2015).
160. *Id.*
161. *Id.*
162. *Id.*

Kinlaw.[163] Still, as previously discussed, the court found that the SEC had established proof that the investments in question were securities that needed to be registered.[164] In fact, the court does not even discuss *Kinlaw* in the *Arcturus* opinion.[165] This treatment of *Kinlaw* shows that courts have disregarded any significance it once held. Thus, defendants should not depend on *Kinlaw* as a strong source of authority when arguing that an operation qualifies as a joint venture.

C. Maintaining Joint Venture Status

If attorneys are to continue directing quasi-brokers of oil and gas interests to utilize the joint venture exemption, they must lay out exactly how the managers are to comply with each of the three *Williamson* factors. As to the first factor, investment managers should be directed to continue gathering investors from one region of the country, or preferably, one state. The solicitation of investors from one region would make it more difficult for the SEC to attack an operation as only offering sham or illusory powers to its venturers.[166] In addition to sticking to one region or when gathering investors from one region is not feasible, managing venturers should put investors into contact with one another as soon as possible. Further, the managing venturer should ensure that they do not restrict investor access to information regarding one another. This can be done in a variety of ways, such as by compiling a secure database of all of the investors' information and giving access to each investor.

As to the second *Williamson* factor, attorneys should direct managing venturers to refrain from the use of cold calls. While the use of cold calls may technically be permitted in a joint venture operation, the courts have recently viewed them as strong evidence that an interest purported to be a joint venture is in reality an investment contract.[167] Managers should instead try to solicit investments from individuals they know or have some professional connection with in the oil and gas industry. To ensure an

163. *Id*.

164. *Arcturus*, 171 F. Supp. 3d at 531.

165. *Id*.

166. The SEC has a limited ability to attack certain interstate transactions. The 1933 Act exempts certain intrastate transactions from disclosure to the SEC if: (1) the security is sold within a single state or territory; and (2) the issuer of said security is a resident and "doing business" within said state. *See* 15 U.S.C. § 77c(a)(11). The SEC defines "doing business" as the issuer deriving at least 80% of its consolidated gross revenues from operations within the state, having at least 80% of assets in the state, and using at least 80% of its net proceeds from sales within the state. *See* 17 C.F.R. § 230.147.

167. *Sethi*, 229 F. Supp. 3d at 536; *Mieka*, 259 F. Supp. 3d at 558.

investment scheme's status as a joint venture, organizers should try to focus not only on individuals with oil and gas experience, but more specifically individuals with experience in the area of drilling and production. Focusing on investors with specific drilling experience clears some of the doubt, if present, that the investors are not experienced in the business of the venture.

The third *Williamson* factor is arguably the most difficult element to comply with for managers of investment operations. Oil and gas drilling projects often require power to be vested in the hand of sole individuals. For example, contractors may require one individual to remain as the holder of the lease, or listed as the operator of the well. Therefore, suggestions on compliance with this *Williamson* factor can leave attorneys in a problematic position when offering advice to clients.

For starters, it is critical that venturers retain access to the investment funds. These funds should be kept in a separate account and not comingled with any other monies. Keeping the money open to investors is a clearly difficult task because of the logistics of allowing over fifty venturers at times to rescind their funds as they please, and subsequently threaten the stability of the operation. However, allowing venturers to have access to the account is important because it ensures that any new managing venturer will be able to access the joint venture's assets to fund drilling operations.

It is also in the best interest of an investment operation to avoid monopolized areas of oil and gas production, such as the Bakken Shale or the Permian Basin. These areas that are dominated by several oil and gas operations often require extensive experience and connections to enter into an exclusive market. To courts, this exclusivity creates the appearance that the venturers are dependent on the managing venturer, and thus without a reasonable alternative option as to a new managing venturer.[168] Managers of investment operations must also walk a fine line when drafting their PPM for potential investors. Courts have considered PPM's that boast about access to an exclusive market as evidence that the investors were without power to remove the managing venturer.[169]

Managers will likely have to show that venturers have a certain amount of control over drilling operations. This control is the most substantial piece of proof to show that investors continue to maintain the ability to replace the managing venturer of a drilling operation. A JVA that purports to grant full power over the drilling operations of a project violates this ability by

168. *Sethi*, 229 F. Supp. 3d at 537.
169. *Arcturus*, 171 F. Supp. 3d at 529-30.

removing the power of investors to affect the direction of the drilling operation.

While theoretically an oil and gas investment operation may be able to retain its joint venture status in limited circumstances based on the foregoing suggestions, it is apparent that the potential for misstep is nearly imminent. The courts have continued to side with the SEC, resulting in case law that supports any future allegation the agency makes against oil and gas drilling operations. This case law shows that a number of common practices involved in the solicitation and management of investors are evidence of an operation's false status as a joint venture. The purpose of this article is to demonstrate the difficulties, and potential liabilities, associated with attempting to maintain a joint venture in the oil and gas industry.

D. Exempting Sophisticated Investors

A greater emphasis should be placed on the second *Williamson* factor involving investor knowledge and experience. Regardless of whether the first or third *Williamson* factor is met, operators partnering with sophisticated investors should be exempt from registering the SEC.[170] As pertaining to the oil and gas industry, sophisticated parties should not be allowed to use securities laws as insurance against the risk of a transaction. When a knowledgeable and experienced party agrees to assume the risk of investing in a drilling prospect, they should not have the opportunity to back out by claiming that the transaction in void because of the operator's failure to register the investment as a security with the SEC. A significant amount of funding for oil and gas projects is generated from sophisticated investors with knowledge of the complexities and volatile nature of the oil and gas industry.[171] To allow these investors to walk away from deals

170. Current federal securities law already provides certain sophisticated investors with protection. The 1933 Act provides that transactions are exempt from registration if they do not involve a public offering. *See* 15 U.S.C. § 77(d)(a)(2). Therefore, private offerings are exempt from the disclosure process. In *SEC v. Ralston Purina Co*., the Supreme Court determined that an offering is private if the investors in an enterprise have the ability to fend for themselves. *See* 73 S. Ct. 981. Lower courts have held that an investor is independent (making the investment a private offering) when they are both informed and sophisticated. Further, the SEC's rules provide that a transaction is also exempt from registration if there are no more than 35 purchasers of securities from an issuer. *See* 17 C.F.R. § 230.506. Additionally, a purchaser with knowledge and experience in a financial matter does not count toward the purchaser limit. Thus, sophisticated oil and gas operations may be excused for disclosure to the SEC if they meet these requirements.

171. Pezold & Richey, *supra* note 74, at 873.

171. *Arcturus*, 171 F. Supp. 3d at 831.

would impair the ability of operators to obtain funding for drilling projects, ultimately impairing the development of production of natural resources.[172] A party who has the ability to accurately assess the risk of a drilling operation based on its experience in the oil and gas industry should not enjoy a free ride on an investment based on federal securities laws. The specific realties of the oil and gas industry must be considered when enacting and applying securities laws to a multifaceted and atypical industry.[173]

To accomplish this objective, Congress should consider drafting an exemption into federal securities laws relating to the experience of oil and gas investors in the industry. Until 2003, the state of Oklahoma had a statute that exempted industry deals in oil and gas from the reach of state security laws. The pertinent section of the statute read:

> Any interest in oil, gas, or mineral lease except that transactions involving leases or interests therein, between parties, each of whom is engaged in the business of exploring for or producing oil and gas or other valuable minerals as an ongoing business, and the execution of oil and gas leases by land, mineral and royalty owners in favor of a party or parties engaged in the business of exploring for or producing oil and gas or other valuable minerals shall be deemed not to involve a security.[174]

A similar exception should be codified into current federal securities laws in order to protect one of the working traditions of investment in the oil and gas industry. An exception would allow for investors in need of protection from security laws to have it but require sophisticated investors to use

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172. *Id*.

173. This article makes the contention that sophisticated oil and gas investors should be allowed to form joint ventures that may legally avoid registration with the SEC. These investors should be held to an agreement made to be jointly liable in the case of failure of an operation because of the fickleness of the oil and gas industry. Oil and gas production often depends on the investment of experienced industry partners to get drilling started. While much of oil and gas production is the product of larger companies, smaller drilling operations are still active nationwide. To allow these sophisticated individuals who invest in smaller operations the opportunity to back out of agreements because of the structure of the operation would be devastating for the oil and gas industry. Less investors would likely lead to less production and threaten the energy interests of the country as a whole. Therefore, courts should weigh more heavily the second *Williamson* factor, concerning experience of the investors, when determining if an operation's joint venture status exempted it from registration as a security interest.

174. OKLA. STAT. ANN. tit. 71, § 2(20)(R) (West Supp. 1984-85).

common law remedies. This distinction between knowledgeable and unknowledgeable investors is important because it allows for an acceptable industry practice to continue.

E. Statutory Clarification

In order to avoid lawyers being placed in the uncomfortable position of giving conflicting legal advice, the securities statutes should be amended to clarify the definition a "security." Further, these securities acts should be amended to clarify exceptions specific to the act. In addition to an amendment exempting operations concerning sophisticated investors from registration, other exceptions should also be carved out if deemed necessary. For example, an amendment should be drafted to specifically define the qualifications an investment operation must have to qualify as a joint venture. While it is a notable point that the common law has developed a definition for a joint venture, at a minimum this law should be codified into federal law. This codification would allow for attorneys to have a more specific source to point to when offering advice, thereby dismissing some of the confusion currently present in the legal community. Further, a federal definition would likely result in a greater consensus in the legal community about which investment operations are required to register and which operations may continue to operate free of SEC regulation. Regardless of whether the definition was crafted to favor the SEC or investment managers, greater consensus in the legal community would benefit all parties involved.

One source of inspiration for revamping the federal securities code might be the Texas State Securities Board's guidelines. The agency provides specific information on the registration of oil and gas programs.[175] Under the Texas code, most individuals who serves as an officer or director of promoters who sell interests in an oil and gas operation must be licensed as broker-dealers.[176] Further, these officers cannot be paid commission in any form related to the sale of the interests.[177] These broker-dealers are responsible for ensuring that oil and gas interests in an operation are only sold to appropriate purchasers.[178] If the federal government were able to

175. *See* 7 TEX. ADMIN. CODE ANN. §§ 121.1-121.4 (McGraw Hill 1979) (The minimum purchase in a drilling program is $5,000.00.)

176. *Id*. § 121.3(d)(1).

177. *Id*.

178. *Id*. § 121.3(d)(3) (A sponsor is required to make a reasonable investigation of the investor's financial capacity to absorb the risk of the investment. Further, the Texas State

codify a similar section into its code concerning registration of oil and gas promoters, much of the confusion arising out of recent case law would likely be resolved.

F. Continued Registration with the SEC

In the absence of change, either in legal advising or statutory definitions, investment operations in oil and gas should err on the safe side by registering with the SEC and following the Commission's rules. Lawyers should advise operators seeking external sources of funds for oil and gas operations to secure both state and federal registration. While discussion about securities regulation usually focuses on the implication of case law challenging the joint venture status of operations in federal courts, operators often must also adhere to state registration requirements.

In conveying the importance of registration, attorneys should make several of the following points. First, put simply, there is a strong argument that federal and/or state law require registration of an operation. While the statute may not be clear, federal courts have put out an increasing amount of case law explaining when the law requires registration. This increasing amount of case law leaves little room for investors to manipulate the system by falsely claiming exempt status for their operations. Second, because of the increase in use of collectively generated funds to fuel oil and gas operations, authorities at both the federal and state level have increased their enforcement efforts. As more investors are at risk of falling pawn to malevolent investment organizers, the SEC will likely continue to come after operations who seek to avoid registration. The increasing amount of cases coming out of federal district courts illustrates the determination of the SEC to hunt down fraudulent joint venture schemes. Third, registering with either the SEC or the relative state agency, while possibly expensive in up-front costs, is relatively inexpensive when considering the potential fines and litigation costs associated with violations of securities laws. Whereas the cost of registering is not by any means a simple or inexpensive one, litigating with the SEC is by no means cheap either. Finally, compliance with security regulations is most often to the benefit of the operator because fulfilment of requirements protects the operator from being penalized on mere technicalities.[179] An operator has a much greater chance of success

Securities Board requires the sponsor to retain all records necessary to substantiate the sponsor's assertion of investor suitability.)

179. William Powers & Don Reser, *Oil and Gas Programs and Broker-Dealer Securities Registration Ramifications*, 13 ST. MARY'S L.J. 803, 823 (1982).

when confronted with an accusation from the SEC when they have complied with these requirements.[180]

While the process of registering might be somewhat taxing to an outsider, Congress has worked to simplify the process. Congress has delegated the responsibility of registering brokers and their employees to the National Association of Securities Dealers (NASD).[181] NASD is a self-regulatory organization that acts under the SEC's oversight and is funded by members of the organization.[182] Once an individual becomes licensed with a NASD-member broker-dealer, that person is approved to sell securities under federal law.[183] The NASD requirements for licensure include passing both a background check and an exam.[184] Individuals who are specifically interested in selling oil and gas securities can take either the Series 7 exam covering general securities representation or the Series 22 exam covering direct participation program limited representatives.[185] All fifty states also accept NASD registration as compliant with state security regulations.[186]

VI. Conclusion

The disappearance of the joint venture as an exemption to the SEC registration requirement in the oil and gas investment industry is apparent. Cases like *Arcturus* and *Sethi* are just a few examples of the many decisions coming of federal district courts in Texas. Further, the SEC has continued to file charges against more oil and gas operations for their failure to properly register investments as securities. Additionally, when heard in court, judges are crushing the operations with summary judgment motions. Judges have relied on the mounds of case law created by the SEC in the past few years. The SEC's persistence in attacking investment schemes has made fighting charges on these counts an uphill battle for operators who fail to register.

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180. *Id.*
181. John Fahy, *Be Mindful of Broker-Dealer Requirements in Oil and Gas Private Placements*, OIL & GAS FINANCIAL JOURNAL (Aug. 1, 2006), http://www.ogfj.com/articles/print/volume-3/issue-8/capital-perspectives/be-mindful-of-broker-dealer-requirements-in-oil-and-gas-private-placements.html.
182. *Id.*
183. *Id.*
184. *Id.*
185. *Id.*
186. *Id.*

The recent securities regulation cases emerging from federal courts in Texas have illustrated the reluctance of courts to grant investment operations the joint venture status. The SEC shows no signs of letting up. As the SEC continues to grind out mounds of case law in its favor, the operator standard for proving a joint venture exists is only raised higher.

The importance of lawyers understanding the ramifications of securities dealings cannot be understated. Operators who fail to adhere to federal security law requirements face potentially severe penalties from the SEC. The potential for penalty should be worrisome to the legal community, especially when there is not a clear consensus on whether or not the joint venture exemption is still available as a defense. Attorney's practicing in both securities and oil and gas law should work to affect adequate outcomes for their clients involved in these specialized investment operations.

Lawyers in most cases should recommend to their clients involved in the oil and gas drilling industry to register their investment operations whether or not they think they qualify as joint ventures. The cost of failing to register, whether in litigation costs or fines imposed by the SEC, almost always outweighs the initial cost to register and comply with SEC requirements. A simple cost-benefit analysis should lead even the chanciest operator to register.