Rome v. HEI Resources, Inc.,
The Continuing Saga of Joint Venture Interests Subject to Colorado Securities Act Regulation

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Colorado federal and state courts have considered whether joint venture interests offered to participants for oil and gas development are securities subject to regulation under federal and state securities laws seven times in the last several years. The most prominent, heavily battled, and long-lasting of these cases is *Rome v. HEI Resources, Inc.*, 2009 CV7181 (Denver District Court, order of judgment issued January 12, 2018). This case is the continuation of three Denver district court decisions in 2011 and 2013 (under the name *Joseph v. HEI Resources, Inc.* (discussed in the October 2013 CBA Business Law Section newsletter) and then *Rome v. HEI Resources, Inc.*, Case No. 2009CV7181 (April 8, 2016) (discussed in the April 2016 newsletter). These cases first narrowed the issues for trial (2011) and then dismissed (2013) the Securities Commissioner's claims against the defendants since the trial court found that a "security" as defined in the Colorado Securities Act was not involved. These decisions were followed by a Court of Appeals decision (*Rome v. HEI Resources, Inc.*, 2014 COA 160, *cert. denied* 2015 WL 5102845 (2015), discussed in the December 2014 newsletter) which advised the trial court it had applied an incorrect analysis. After remand, in a 33-page April 2016 decision, the Denver District Court concluded that the joint venture interests in question were securities under Colorado law and that the defendants offered and sold securities.

The District Court then ordered trial on the Colorado Securities Commissioner's remaining claims from the 2009 litigation: the alleged violations by HEI Resources' and the other defendants of the registration, licensing, and anti-fraud provisions of the Colorado Securities Act and the damages, fines, and other penalties appropriate for such violations. That trial was held in the fall of 2017, and Judge Michael A. Martinez issued his decision in January 2018. This article focuses on that decision and a subsequent related order by Judge Martinez.

The *HEI Resources, Inc.* cases do not stand alone in this area. Other cases involving these oil and gas joint venture interests being regulated under the Colorado (and federal) securities laws are:

- *Joseph v. Mieka Corp.* (discussed in the May 2012 newsletter), which upheld the Colorado Securities Commissioner's cease and desist order against Mieka Corp. and others for unlawful sales of securities and lack of broker-dealer registration.

- *SEC v. Shields* (discussed in the September 2012 newsletter) in which the federal district court dismissed an SEC enforcement action on a Rule 12(b)(6) motion. The dismissal was reversed and the case remanded by the Tenth Circuit in February 2014 (744 F.3d 633 (10th Cir. 2014) and discussed in the April 2014 newsletter). On remand the court entered an injunction and other sanctions against Mr. Shields. (In another Colorado state case, Jeffory Shields was convicted of two counts of securities fraud and (in August 2014) was sentenced to eight years in prison and ordered to pay $5.6 million in restitution.)

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The Joint Ventures At Issue

As in *Mieka* and *Shields*, the *HEI Resources* joint venture agreements purported to give the owners the right to participate in the operation of the joint ventures through voting, the right to receive information, and the right to remove the venture manager (the promoter in each of the cases). In each case, the promoters solicited participants in the ventures through phone banks which called up to thousands of prospective participants throughout the United States. However, only HEI or its manager, Heartland Energy Development Corporation, ("HEDC") (collectively the "venture manager") had the authority to bind a joint venture.

In each of the Colorado cases and in many of those brought elsewhere, the allegations suggested that the venture manager entered into turnkey drilling contracts that would govern the ventures when formed and would continue to govern the ventures even if the venture manager were dismissed. Because of the cost of the turnkey contracts to the venture manager and the much higher cost to the venture paid by the investors, the venture manager received significant undisclosed compensation. In none of the disclosure documents was typical securities "full disclosure" provided regarding related party transactions and compensation.

HEI and HEDC employed sales representatives for the joint venture interests, which they sold by cold-calling individuals throughout the United States. The eight ventures involved in the *HEI Resources* litigation each had from 46 to 90 investors. Each investor signed a subscription agreement which put them on notice that they would be expected to exercise their management rights under the various joint venture agreements. Each investor was also obligated to represent that he or she possessed "extensive experience and knowledge in business affairs such that he or she is capable of intelligently exercising his or her management powers" and that they would not be relying on any "unique entrepreneurial or management ability of the managing venturer." There was no requirement that the investors had oil and gas industry experience. Ultimately, the HEI defendants raised more than $58 million from a large number of investors. The investors who testified ranged from 48 to 78 years of age at the time they made their investment. Few had any experience investing in oil and gas drilling ventures. The court reviewed in detail the qualification and testimony of 17 investors, concluding that the investors possessed (as a group) significant business knowledge, but little knowledge in the oil and gas industry, and had no ability individually or as a group to control the operations. That being said, the court had little trouble in April 2016 finding that the joint venture interests were securities under the Colorado Securities Act.

Joint Venture Interests As Securities

As an initial comment, it is important to note that the defendants did not admit that the joint venture interests were securities. In fact, the court noted (page 19) that the defendants continued to maintain that "the joint venture partnership interests are not securities under the Colorado Securities Act and as such, the securities provisions do not apply." In light of its April 2016 finding, however, the court refused to revisit that argument.

In defending against the alleged violations of the Colorado Securities Act, the principal argument that the defendants made was that, until April 2016, no court in several trials had

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determined that the HEI joint venture interests were securities. In a 2002 final order issued by the Securities Commissioner, the Commissioner found that "there was insufficient evidence to determine whether the defendants sold securities." The defendants alleged that they relied on legal advice and the 2002 final order in acting in good faith and, as such, were immune from prosecution under the Colorado Securities Act by reason of C.R.S. § 11-51-704(4). The court held that the Commissioner's 2002 final order made no such finding, but that reliance on advice of counsel is not an absolute defense, but merely a factor for the fact-finder to weigh in determining whether the defendants acted with *scienter* – not whether the instruments were, in fact, securities.

Since securities were involved, however, the court easily found that the defendants "Davis, Pollak, and Schiffner sold . . . joint ventures without being licensed to sell securities" for commissions in violation of C.R.S. § 11-51-401.

Because the sale of securities was involved, the court applied the heightened rules for disclosure requirements found in securities laws. The court catalogued a list of disclosure failures in the confidential offering memorandum prepared by HEI in connection with the offer and sale of joint venture interests, which memorandum was used by the sales representatives, and found that the omissions were not only material but also made with *scienter* (which is a required element since the Securities Commissioner was seeking damages, restitution, and equitable relief). Among the material omissions the court found were:

- A failure to disclose that Joe Kinlaw was a control person and key officer at both HEI and HEDC and a further failure to disclose an SEC injunction issued against him – "omit[ing] information that a reasonable investor would consider important in making a decision about whether to invest," "intentionally omitted with intent to defraud investors." (Pg. 22)
- A failure to disclose the total number of dry holes in the area resulting in defendants "materially mis[leading] investors by highlighting the successful wells in the preview package and then disclosing the risks at a subsequent date." (Pg. 26)
- A failure to disclose important financial information, "including AFE's, actual cost reports, and financial status reports" which the court found were "important [to the investors] in making an investment decision." (Pg. 28) "Defendants' business practices support the inference that a reasonable investor would find the AFEs and financial information important prior to investing." (Pg. 29)

Interestingly, the court found that the sales agents disclosed commissions to investors who asked, and therefore found that the failure to set forth commissions in the memorandum was not an omission of material information. (Pg. 30)

- In the end, the court found that under *Joseph v. Equity Edge, LLC*, 192 P.3d 573 (Colo. App. 2008), public interest favors an injunction against the defendants under C.R.S. § 11-51-602 and "permanently enjoin[ed] Defendants, their agents, servants, employees, and successors . . . and all those in active concert or participation with any Defendants" from violations of numerous provisions of the Colorado Securities Act.

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- The court also awarded restitution under C.R.S. § 11-51-602(2), but found that "the record is insufficient to award a monetary judgment at this time." (Pg. 38)

The defendants have filed motions with the trial court for reconsideration. It can be fairly certain that this decision will be appealed to the Colorado Court of Appeals (which has found against the defendants in 2014), and likely then to the Colorado Supreme Court.

Judge Martinez's Class on the Colorado Securities Act ("CSA")

Judge Martinez's decision provided an excellent review of the facts important to the court in determining the applicability of the Colorado Securities Act, registration, licensing, and disclosure requirements, as well as a review of the facts in *HEI Resources* the court determined to be important to the case. The decision also provides an excellent primer on the Colorado Securities Act and years of Colorado case law:

- *People v. Prendergast*, 87 P.3d 175 (Colo. App. 2003), finding that C.R.S. § 11-51-501 (the "antifraud provision") "is intended to protect investors while avoiding unreasonable burdens on participants in the market."
- *Black Diamond Fund, LLP v. Joseph*, 211 P.3d 727 (Colo. App. 2009) noting that while C.R.S. § 11-51-602 and -604(4) create antifraud liability and do not require *scienter* when seeking an injunction, § 11-51-602 does require that the Commissioner prove *scienter* when seeking damages, restitution, or disgorgement also citing *Boettcher & Co., Inc. v. Munson*, 854 P.2d 199 (Colo. 1993). *Scienter* was "defined as intent to deceive, manipulate, or defraud," citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), *People v. Terranova*, 563 P.2d 363 (Colo. App. 1976), and *Black Diamond*.
- *Goss v. Clutch Exchange, Inc.*, 701 P.2d 33 (Colo. 1985) defining a "material fact" for the purposes of the Colorado Securities Act as "any information that an investor would consider important in making an investment decision, *i.e.*, whether a reasonable investor would regard the facts as 'significantly altering' the mix of information provided."
- *Lowery v. Ford Hill Inv. Co.*, 556 P.2d 1201, 1205 (Colo. 1976) to the effect that a "misrepresentation under the CSA may occur 'in the promotion or negotiations for the sale of a [security].'"
- *People v. Hoover*, 165 P.3d 784 (Colo. 2006), holding that belief or reliance on counsel on whether the instrument in question is a security is irrelevant to the securities fraud allegation. *See also People v. Rivera*, 56 P.3d 1155 (Colo. App. 2002).
- *Joseph v. Equity Edge, LLC*, 192 P.3d 573 (Colo. App. 2008) holding that "the test for permanent injunctive relief under the CSA requires (1) that a past or threatened future violation of the CSA exists, (2) that the injunction would not disserve the public interest, and (3) that the public interest favors the injunction."

In his 2016 decision concluding that the joint venture interests in *HEI Resources* were securities, Judge Martinez cited to *Securities and Exchange Commission v. W.J. Howey Co.*, 328 U.S. 293 (1946), and in Colorado, *Lowery v. Ford Hill In. Co.*, 556 P.2d 1201, 1205 (Colo. 1976) and *Joseph v. Mieka Corp.*, 282 P.3d 509 (Colo. App. 2012). The District Court cited the three

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prongs of the *Howey* test, used to determine whether a joint venture interest is an investment contract, as follows:

(1) a contract, transaction or scheme whereby a person invests his money;
(2) in a common enterprise; and
(3) is led to expect profits solely from the efforts of the promoter or a third party.

As noted by the Court of Appeals in 2014 and repeated by the District Court in 2016, the word "solely" in the third Howey factor has not been read literally; rather, the "critical inquiry is instead whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise," citing *Long v. Schulz Cattle Co., Inc.*, 881 F.2d 129, 133 (5th Cir. 1989) (internal quotation marks omitted); *Toothman v. Freeborn & Peters*, 80 P.3d 804, 813 (Colo. App. 2002); and *Joseph v. Viatica Mgmt., LLC*, 55 P.3d 264, 266 (Colo. App. 2002).

This test is intended to "embod[y] a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." *Howey*, 328 U.S. at 299; *see also Lowery*, 556 P.2d at 1205. The District Court identified "the dispositive inquiry" as being "whether the investor was 'led to expect profits derived from the entrepreneurial or managerial efforts of others'" (*citing Toothman*, 80 P.3d at 811).

In several of the earlier *HEI* cases*,* Judge Martinez and his predecessor on the case, Judge Hoffman also reviewed at length the applicability of and the elements of *Williamson v. Tucker*, 645 F.2d 404 (5th Cir. 1981) – a general partnership case holding that when one of the three *Williamson* factors are present, a security could be found. The *Williamson* factors are:

1. The agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership;
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
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.

Finally, Judge Martinez also discussed extensively (in 17 single-spaced pages in the January 12, 2018 order of judgment) the facts he determined and applied them to the law he discussed to reach his judgment.

It is important to note that the Securities Commissioner did not win on all issues. The Court dismissed the Securities Commissioner's claim against Bedrock Energy Development, Inc. pursuant to C.R.C.P. 41(b) because the Commissioner failed to prosecute any claims against Bedrock. The court also recognized the "reliance on counsel" defense as a mitigating element, although definitely not for exoneration. Generally, however, the Securities Commissioner obtained substantially all of the remedies he sought.

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Another Issue – The Bad Actor Disqualification

While still maintaining that the joint venture interests were not securities, the Defendants moved the Denver District Court to modify its earlier judgment because the injunction prevents the Defendants from taking advantage of certain securities offering exemptions for their existing, and presumably lawful, business practices. Because the Court found that the Defendants committed fraudulent acts in connection with the offer and sale of securities and issued an injunction to prohibit future such acts, the Defendants became "Bad Actors" as defined by a number of state and federal rules and regulations. As "Bad Actors", the Defendants cannot take advantage of the exemptions from registration for the offer and sale of securities under SEC Rule 504 or Rule 506, SEC Regulation A or Regulation CF, and the Colorado Crowdfunding Act. The Defendants claimed that the injunction produced an unjust result by disqualifying them from continuing to rely on such exemptions.

By its order issued February 14, 2018, the Court refused to modify the injunction, holding that:

> Because the Defendants acted with an intent to defraud, they constitute "Bad Actors" within the meaning of Rule 506. [*Citation omitted*] The SEC has made an express determination that the public interest is best served by excluding such actors from Reg D offerings. [*Citation omitted*] The *Joseph* factors therefore weigh heavily against any modification of the injunction which permits Defendants to take advantage of Reg D offerings.

The Court noted that the Defendants are not without other relief (in that they may still petition the Colorado Securities Commissioner for a state waiver or the SEC for a federal waiver). However, the Court refused to grant the relief requested finding that "the public interest demands that Defendants should be subjected to the full extent of the consequences for securities fraud as set forth in Rule 506 and as implicated by the injunction entered."

Conclusion

After a number of cases, and different, even contradictory decisions by state and federal courts in Colorado, the conclusion from *Shields, Mieka* and now *HEI Resources* is that, unless extremely carefully structured, joint venture interests in oil and gas drilling programs will be securities for the purposes of federal and state securities laws. It is clear in Colorado that the *Williamson* presumption does not apply, and the economic realities of any quasi-investment opportunity must be considered. The economic realities test can be summarized as follows: "if it looks like a security and walks like a security and talks like a security, it will be treated as a security."

None of this is new. As stated in prior newsletter articles on this subject, cautious lawyers should advise their clients to treat these broadly-marketed joint venture interests as securities (whether in the oil and gas industry, real estate, or other industry).

When establishing legitimate joint ventures not subject to securities regulation, between persons who are substantially equals capable of negotiating their arrangements, found without a

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general public solicitation, and who truly share decision-making power, accurate disclosure is still the best course. As Justice Louis Brandeis said in 1914: "Sunlight is said to be the best of disinfectants; electric light is the most efficient policeman. . . ." [OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT at 92, 104 (1914, Augustus M. Kelley ed. 1971).] This is still true in business disclosure 104 years later whether securities are involved in a transaction or not.