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Are Interests in Oil and Gas Joint Ventures Securities? Two Cases that Say "No" and One that Says "Yes"

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In 2011, the SEC brought an enforcement action against Jeffory Shields and his company, Geodynamics, Inc., for what the SEC alleged were the fraudulent and unregistered offer and sale of securities styled as joint venture interests in oil and gas drilling programs. In *SEC v. Shields and Geodynamics, Inc.*,[1] the United States District Court for the District of Colorado (Hon. Robert E. Blackburn) denied the SEC's motion for a temporary restraining order ("TRO") finding that the SEC had not proven that the interests defendants offered were in fact securities.[2]

The threshold jurisdictional issue addressed by the Court was whether the joint venture interests in question were a security, because if a security[3] was not involved, the SEC did not have jurisdiction.[4] In the order, Judge Blackburn advised that he applied the factors set forth in *Howey*[5] to determine whether a "security" was involved. The court described these factors as follows:

(1) An investment;

(2) In a common enterprise;

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1 C.A. 11-cv-02121-REB (D.Colo.), order re: Motion for Temporary Restraining Order dated August 26, 2011.

2 The court did, however, order that defendants preserve records during the pendency of the litigation.

3 The term "security" is defined in Section 2(a)(1) of the Securities Act of 1933 and in Section 3(a)(10) of the Securities Exchange Act of 1934.

4 Chapter 2 of Lidstone, *Securities Law Deskbook* (www.bradfordpublishing.com) provides an extensive discussion of the "Definition of a Security."

5 *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). In *Howey*, the Court was analyzing the term "investment contract" which is included in the definition of "security" in §2(a)(1) of the Securities Act of 1933.

(3) With a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.[6]

Judge Blackburn said that he "focused particularly on the third element of this test in reaching my conclusions and considered carefully the decisions that have considered the circumstances under which an investor had 'a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.'"[7]

The Court's order did not describe the facts in any significant detail, but the briefs do at length. It appears that the joint ventures in question were formed under Texas law and were governed by written joint venture agreements and the Texas Business Organizations Code.[8] The SEC alleged[9] that Jeffory D. Shields and Geodynamics

> "defrauded at least 64 investors in 28 states of over $5 million since January 2010 through fraudulent and unregistered securities offerings of interests in four oil and gas investments, attracting investors through boiler-room cold-calls [promising returns of up to 548%]. They continue to seek new investors in their fraudulent scheme based in Colorado."

The SEC further alleged that instead of using the funds for the intended purposes, "Shields has used investor deposits as a personal slush fund, taking over $2 million to pay for personal expenses, including a Learjet, luxury vehicles, travel, designer clothing, sporting events, rent for homes in Colorado and Florida, home furnishings, electronics, jewelry, and cash withdrawals and transfers to personal accounts." In the SEC Memorandum, the SEC alleged that the defendants spent just $613,494 on oil and gas drilling operations – according to the SEC an amount less than was spent on the Learjet.

As is the case with many other oil and gas ventures, the SEC noted that Shields and Geodynamics attempted to "evade federal and state securities regulation" by claiming that the offerings were joint venture interests, not securities, and therefore not subject to the securities laws. As in a case currently before the District Court in and for the City and

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6 *Citing Banghart v. Hollywood General Partnership*, 902 F.2d 805, 807 (10th Cir. 1990).

7 *Slip op.* at 4. Although Judge Blackburn did not discuss the case of *Williamson v. Tucker*, 645 F.2d 404 (5th Cir. 1981) at length in his order, courts have used the *Williamson* analysis to determine whether the investors had a "reasonable expectation of profits from the entrepreneurial or managerial efforts of others." *See* text at notes 13-18, below.

8 Geodynamics, Inc.'s Response to the SEC's motion for a TRO at 2.

9 *Memorandum of Law in Support of Motion for Temporary Restraining Order and Other Emergency Relief* filed by the Securities and Exchange Commission (the "SEC Memorandum").

County of Denver[10] and in a similar case brought before the Colorado Securities Board in a cease-and-desist proceeding under the Colorado Securities Act,[11] the defendants claimed that the Texas joint venture interests were not securities. Even assuming that Shields misled the joint venture participants and misappropriated funds, unless the SEC can establish the jurisdictional threshold that a security is involved, it would not have jurisdiction over this case. Based on Judge Blackburn's initial order in this case, the SEC was not able to convince him that a security was involved.

The SEC alleged that the defendants offered a 'turnkey' oil and gas investment, meaning "that in exchange for a set price investment (the 'turnkey contract price'), each investor will be entitled to receive a set percentage of any future profits from oil and gas production achieved by Geodynamics at the well location at which the investor is investing." The documentation explained that if the turnkey contract price was less than the total cost, Geodynamics would be responsible for the additional cost; if the turnkey contract price was greater than the cost to drill the well, Geodynamics would keep the difference. The documentation made it clear that each of the joint ventures and its operations "shall be managed and controlled collectively by the Venturers" although the Venturers delegated day-to-day management to Geodynamics as managing venturer. In the SEC Memorandum, the SEC alleged that the rights and powers given to the investors were "illusory," resulting in the investors being dependent on the managing venturer for any profits.

In the SEC's Reply in Support of its Motion for a TRO, the SEC further alleged that "[f]rom the beginning, Defendants precluded investors from controlling and supervising their investments. . . . But from the beginning, Defendants denied investors control and supervision by misrepresentations and omissions. . . . The investors could never exercise control and supervision over their investments because Defendants, from the beginning, lured investors with false promises of how their money would be used and how the 'joint ventures' would operate, then prevented investors from learning the truth and controlling and supervising the investments."

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[10] *Joseph v. HEI Resources, Inc.*, Case No. 09CV7181, Courtroom 280, trial court opinion filed Jan. 6, 2011, filing ID 35236907. On January 19, 2012, the Division of Securities entered into a settlement agreement with several of the defendants (Gulf Coast Western, LLC, and its principals, the "GCW Parties") by which they were dismissed from the litigation. In the settlement agreement, the GCW Parties agreed to cease any Colorado business operations and not to offer or sell joint venture interests within Colorado. The Division agreed that these conditions would lapse after a period of time (two years in the case of offering or selling joint venture interests within Colorado; three years in the case of business operations in Colorado) or if a Colorado court (including the *HEI Resources* action, the *Mieka Corp.* action, or three private actions (*Barnhill*, *Mathers Family Trust* and *Snip*) reached a non-appealable decision that a joint venture interest was not a security.

[11] *In re Mieka Corporation* which is available at http://www.dora.state.co.us/securities/pdf_forms/enforcement/mieka-findings.pdf. This finding is being appealed to the Colorado Court of Appeals (11 CA 1080).

The Defendants, predictably, disagreed with the SEC's allegations. In the Defendants' response to the SEC's motion for a TRO ("Defendants' Response"), the Defendants alleged that "the partners were not passive investors and not precluded from exercising control and supervision over their own participation in this joint venture. To support this statement, the Defendants attached an affidavit of Glenn Carroll, a partner in two of the joint ventures, which stated in material part:

> 1. … 2. … 3. …
>
> 4. I am an experienced businessman and have a general understanding of the oil production business. I decided to take part in this partnership, in part, because of the options given to me by my Partnership Agreement.
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> 5. I have been involved in a number of Partner calls and meeting reviews, and have always had access to business information.
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> 6. I have had appropriate opportunities to exercise my partnership discretion.
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> 7. I have been able to obtain necessary information about the business decisions of the Partnership.
>
> 8. I have never considered this monetary decision to be an investment in a security.

According to Judge Blackburn's order, Mr. Carroll also testified at the TRO hearing, and Judge Blackburn "found Mr. Carroll to be a particularly cogent, credible, and persuasive witness in support of defendants' opposition to the motion."

Thus the Defendants won the first skirmish, probably on the strength of the testimony of Mr. Carroll and the Defendants' choice of the best witness[12].

In a similar case before the District Court in and for the County of Denver (the "*HEI* case"), the Hon. Morris Hoffman discussed at length the Fifth Circuit case of *Williamson v. Tucker*[13] under Colorado law and applied it to promoters offering an oil and gas program

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[12] Subsequently Geodynamics filed a motion to dismiss the case under F.R.C.P. Rule 12(b)(6) and, on October 18, 2011, the SEC filed a response repeating allegations in the complaint that, among other things, Geodynamics precluded the investors control and supervision, rendering them essentially passive. Given the nature of the motion to dismiss and response, the SEC relied on the allegations in the complaint and did not address Mr. Carroll's testimony.

[13] 645 F.2d 404 (5th Cir. 1981).

that was established and operated very similarly to the program in the *Shields* case.[14] Judge Hoffman also noted that this case, brought by the Colorado Securities Commissioner, depended on whether the interests that were offered and sold could be considered to be securities under Colorado law and, in doing so, said that under *Williamson* "there is a strong presumption that general partnership interests are not investment contracts and therefore not securities" and that those seeking to overcome that presumption "have a 'difficult burden' to overcome."[15] The Court then applied the three *Williamson* factors as follows:

1. The burden could be overcome if the agreement between the parties leaves so little power in the hands of the non-managing general partners that the arrangement is tantamount to a limited partnership. The Denver Court found that this was not the case in this case and detailed the powers of the general partners exercisable by simple majority vote of the interests.[16]

2. The burden could be overcome if the non-managing general partner were so dependent on some unique entrepreneurial or managerial skill of the promoter or manager that they could not realistically replace the promoter or general partner – a fact that the Court found did not exist in connection with the operation of oil and gas properties which were at issue in the case.

3. The burden could be overcome if a particular non-managing partner was "so inexperienced and unknowledgeable in business affairs that he or she is incapable of intelligently exercising partner powers."[17]

The Court reached no conclusion on the third *Williamson* factor, but granted summary judgment to the Defendants on the first and second *Williamson* factors. It should be noted that the State of Colorado objected to the application of the *Williamson* factors claiming that Colorado courts had never previously adopted the *Williamson* presumption

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[14] *Joseph v. HEI Resources, Inc.*, Case No. 09CV7181, Courtroom 280, trial court opinion filed Jan. 6, 2011, filing ID 35236907. Citations are to the slip opinion. For a similar case in a contested cease and desist matter brought by the Commissioner against Mieka Corporation and certain of its principals discussing Colorado law, see the findings of fact, conclusions of law, and initial decision of the Securities Board hearing panel which is available at http://www.dora.state.co.us/securities/pdf_forms/enforcement/mieka-findings.pdf.

[15] *Joseph*, slip op. at 6. In *Nunez v. Robin*, 415 Fed. Appx. 586, 2011 WL 817523 (5th Cir. 2011), the Court found that a partner in a joint venture who had the knowledge and expertise to exercise his managerial powers and actively did so could not rebut the "strong presumption" that a joint venture interest is not a security.

[16] *Joseph*, slip op. at 9-10.

[17] *Joseph*, slip op. at 6.

"because Colorado consistently analyzes the economic realities of the investment" in determining whether a security is present.[18]

In addition to the two judicial proceedings, in 2011 the Colorado Securities Commissioner brought a cease and desist proceeding against Mieka Corporation and two of its principals to prevent them from offering Texas joint venture interests in violation of the securities laws.[19] Counsel to the Defendants made similar arguments – that the joint venture interests did not constitute securities and, therefore, the Securities Commissioner did not have jurisdiction. The staff of the Securities Division argued to the contrary and a principal focus of the argument was whether, in light of Colorado precedent, the *Williamson* presumption to shift the burden of proof should apply. The respondents argued that the *Williamson* presumption should be applied to shift the burden of proof whether the joint venture interests constituted securities to the Securities Commissioner; the staff argued that, based on Colorado precedent, the *Williamson* presumption should not be applied.[20] The hearing panel did not apply the *Williamson* presumption,[21] but found "the three *Williamson* factors [to be] instructive in performing an economic realities analysis regarding interests in general partnerships and joint ventures."[22] Based on the economic realities test as interpreted by the hearing panel and in applying the facts of the case as presented at the hearing,[23] the panel in the *Mieka Corporation* case found that the oil and gas joint venture

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[18] *See* the Colorado Securities Commissioner's petition to the Colorado Supreme Court pursuant to Colorado Appellate Rule 21 for a writ of *mandamus* setting aside the trial court's order following *Williamson,* and therefore putting the burden on the Securities Commissioner to overcome the *Williamson* presumption that joint venture interests are not securities. The Supreme Court did not grant the petition.

As plaintiff in this matter, it should be noted that the Securities Commissioner has the burden of proving that he has jurisdiction – that a security is in fact involved. Whether this is the *Williamson* presumption or merely the normal allocation of the burden of proof is a question that does not appear to be important.

[19] See the "Findings of Fact, Conclusions of Law, and Initial Decision" (the "Initial Decision") for *In re Mieka Corporation* (April 8, 2011) which is available at http://www.dora.state.co.us/securities/pdf_forms/enforcement/mieka-findings.pdf.

[20] *Toothman v. Freeborn & Peters*, 80 P.3d 804 (Colo. Ct. App. 2003) and *Feigin v. Digital Interactive Associates, Inc.*, 987 P.2d 876 (Colo. Ct. App. 1999). The hearing panel also cited Callison, *Changed Circumstances: Eliminating the Williamson Presumption that General Partnership Interests are not Securities*, 58 BUS LAW 1373 (2003), for the proposition that the *Williamson* presumption should no longer be applied. *See* paragraph 64 of the Initial Decision.

[21] Initial Decision, paragraph 64(e).

[22] Initial Decision, Paragraphs 61(e).

[23] Among the facts cited by the panel leading to the conclusion that the joint venture interests were, in fact, securities, were that:

interests were securities.[24] Based on the panel's decision, the Securities Commissioner issued the cease and desist order. The respondents appealed, but the Court of Appeals affirmed.[25] For business lawyers, the most significant part of the case is the manner in which the Court of Appeals dealt with the *Williamson v. Tucker*[26] presumption that interests in general partnerships are not securities. The Court of Appeals did not take the opportunity to determine whether the *Williamson* presumption is applicable in Colorado, saying: "[w]e need not address this contention because, contrary to the respondents' contention, we conclude the Commissioner's refusal to apply the *Williamson* presumption was not dispositive."[27] As a result and as stated by the Court of Appeals in *Mieka*,[28] the *Williamson* presumption has still not been expressly adopted by an appellate court in Colorado.

Both the *HEI Resources* case and the *Shields* case are continuing before their respective courts. Because of the large number of investors involved, it is possible (perhaps likely) that not each investor in the *Shields* case will be as sophisticated or cogent as Mr. Carroll. Judge Hoffman (who subsequently recused himself) left the door open for the examination of each investor in the *HEI Resources* case even while adopting the *Williamson* presumption.

Whether courts apply the *Williamson* presumption, the *Howey* principles described by Judge Blackburn, or the "economic realities" test, the sophistication and the participation of the joint venturers will undoubtedly be a factor in these and future cases involving oil and gas joint venture interests. The time for the application of these tests is also important.

(i) (unlike in a normal general partnership) investors were not agents of the joint venture with the right to bind the entity,
(ii) investor votes had not been taken and there was no evidence presented of investor participation in the joint venture management,
(iii) the respondents had not inquired into investor oil and gas industry sophistication before taking investor funds,
(iv) the purchase of potential investor lists and cold-calling suggests that there were no or minimal prior relationships; and
(v) the number of potential investors led the panel to conclude that there may be so many investors that a vote "would be more like a corporate vote" (citing *Feigin*, 987 P.2d 882).

[24] The Initial Decision, as are all Colorado Securities Division cease and desist actions, is available by the date the press release reporting the decision, is issued. These can be located at: http://www.dora.state.co.us/securities/enforcement.htm#CeaseDesist.

[25] *In re Mieka Corporation*, 2012 COA 84 (Colo. App. 5/10/2012).

[26] 645 F.2d 404 (5th Cir. 1981).

[27] *In re Mieka Corporation*, 2012 COA 84 at ¶22.

[28] *In re Mieka Corporation*, 2012 COA 84 at ¶18.

Clearly these tests should not be applied in hindsight – months or years after the sale was made. The tests should be applied and the determination should be made as of the time of the investment, not based on facts that developed thereafter.

Persons seeking to avoid the applicability of securities laws to these oil and gas joint venture interests should ensure that each of their investors is as sophisticated as Mr. Carroll in the *Shields* case and has the right to participate in management. The fact that the investors actually participates in management will probably have a later probative value but ultimately the issues should be judged based on the facts and intentions at the time of the investment.