

From Derricks to Desktops – litigation in the oil patch

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Why are we seeing an increase in litigation in the Oil and Gas Industry?

1. Market Volatility - Most companies enter into long-term contracts. When prices change, parties:
 - a. Seek to reduce their exposure or
 - b. Maximize their returns
2. When prices go down:
 - a. Cost-cutting occurs
 - b. Canceled contracts
 - c. Stalled exploration, etc.
 - d. "Expenses" increase

Setting the Stage

Market Volatility



Recent Oil and Gas Royalty Litigation

In 2016, the SEC brought a civil action to the self-described “frack master”, for a \$71m scheme that began in 2011 in the Permian Basin. Allegations included false statements:

1. About his experience
 - He had little, if any
2. Cost estimates
 - Grossly inflated AFEs by 10 times or more
 - Operating costs of \$2.6m were altered to read \$25m
3. Use of investor funds
 - \$30m on personal expenses, such as meals, entertainment, travel, cars, jewelry, strip clubs and escorts
4. Oil and gas projections
 - Similar to costs, at 10x

Recent Oil and Gas Royalty Litigation



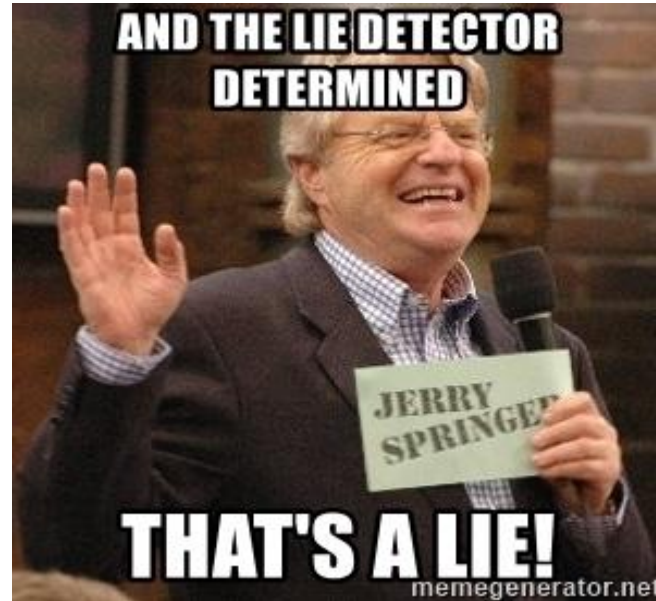
Can't stop won't stop

According to a SECOND SEC's complaint, which was filed under seal on **September 11, 2017**, Faulkner orchestrated a scheme to deceive and mislead investors about Faulkner's latest venture, Homes Inc., by claiming that it:

- had a proven and extensive track record of offering and selling passive real estate investments to investors;
- used investor funds for the acquisition, renovation, and re-sale of residential real estate in Southern California; and
- consistently produced double-digit returns to its investors.

And.....

Recent Oil and Gas Royalty Litigation



Recent Oil and Gas Royalty Litigation



The master plead guilty in October 2018 in the TX matter, and faces:

1. 12 years in prison
2. \$350,000 in fines
3. Disgorgement of ill-gotten gains

His mom, who is an attorney, is currently being sanctioned after misrepresenting the dismissal of an ancillary state lawsuit, in which she presented no evidence of an resolution, and the adverse party presented evidence that undermined her claims.

Recent Oil and Gas Royalty Litigation



Royalty Litigation Trends Identified at IEL's 69th Conference 2018:

▶ Pricing

- Definitions of "market value"
- "Best price reasonably possible"
- Affiliate Sales
- Valuation point (Wellhead? Plant?)

▶ Deducts

- Post-production costs (transportation)

Recent Oil and Gas Royalty Litigation (continued)

- ▶ **Misrepresentations by brokers/companies**
- ▶ **Breaches of contract:**
 - Right to audit clauses
 - Maintaining books and records
 - Timely reporting
 - Mediation/Dispute Resolution



Methods Commonly Used To Calculate Royalty Payments

Royalty Clauses often differ and can establish the royalty payment:

- At the well (absent the production costs)
- At the pipeline
- Point of sale
- Or at a delivery point (which would have production costs deducted from the payment)



Methods Commonly Used To Calculate Royalty Payments (continued)



Market Price

- The royalty payment is based on the price of oil or gas at point of sale.
- Market price can also be calculated by using the highest price or the posted percentage for fields that are 100 miles or any major oil company extracting a similar grade and gravity the day the oil is removed.

Methods Commonly Used To Calculate Royalty Payments (continued)



▶ **Actual revenue received from the sale**

- Mainly used with gas royalties

▶ **“In-kind” royalties**

- The landowner takes possession of the oil or gas produced before it is marketed.

Oil and Gas Royalty Fraud (continued)

Glaring Red Flags:

- ▶ Sales pitches focused on highly publicized events (i.e. volatile oil prices, de-regulation, etc.).
- ▶ “Can’t miss” wells (no such thing as “guarantees”).
- ▶ Unsolicited materials – ignore investment-related “junk” faxes, emails, voice mail messages, and regular mail.
- ▶ Limited opportunities (limited because...?).
- ▶ Compare promised rates of returns with that of industry (too good to be true?).
- ▶ Tips or secrets.
- ▶ Drillers and operators turned executive (trading in their hardhats for iPhone?)



On the Offensive – Combatting Fraud



State securities regulators around the country warn that oil and gas investment scams are alive and well.

- ▶ **Ask questions and understand the answers.**
- ▶ **Contact state oil and gas regulatory agencies.**
 - Railroad Commission of Texas oversees the Texas oil and gas industry.
- ▶ **Research the company before you invest.**
 - Contact secretary of state to find out whether the company is a corporation in good standing.
 - Check out the company's financial statements on the SEC's website or contact your state securities regulator.

On the Offensive – Combatting Fraud (continued)



State securities regulators around the country warn that oil and gas investment scams are alive and well.

▶ **Know the salesperson.**

- Check out the disciplinary history of brokers and advisers using the SEC's and FINRA's online databases. State securities regulator may have additional information.

▶ **Send all complaints to:**

- www.sec.gov/complaint.shtml
- www.finra.org

On the Offensive – Combating Fraud (continued)

Right to Audit Clauses

▶ **Rights to access and analyze books and accounts and confirm performance and accuracy of the licensees records. Provides:**

- Access by a third party or group of investors
- Remedies, such as payment of the legal and audit expenses of the offended party.
- Process to resolve disputes to avoid unnecessary litigation that may harm the future of the agreement between the parties.



On the Offensive – Combating Fraud (continued)



DO the DUE - Performing Due Diligence

▶ **What is the name and address of the operator?**

- What is her/his experience with ventures of this nature?
- What are the terms of the agreement with the operator, including the compensation terms?

▶ **Who will be responsible for payment of taxes?**

- Will they be paid out of the investor's share?

On the Offensive – Combating Fraud (continued)



DO the DUE - Performing Due Diligence

- ▶ **What is the location of available pipelines, or what method will be used to transport and sell any production?**
- ▶ **How will the decision be made for completing the well or abandoning it?**
 - Who will make that decision?
 - What is to become of funds received from the salvage value?

On the Offensive – Combating Fraud (continued)



Federal False Claims Act

- ▶ **The federal government's most effective and successful tool in combating waste, fraud and abuse in federal spending.**
- ▶ **In total, the Department of Justice and the Office of Natural Resources Revenue (ONRR) have collected:**
 - \$3.014 billion from settlements, fines and audits, according to the research, compared with \$11 billion in revenues the U.S. government collects on average each year from oil, gas and mining leases.
 - Over two-thirds of the money, or \$2.221 billion, was from audits conducted by ONRR to check whether royalties were accurately calculated.

Avoiding “Land Mines”

The Sale of oil and gas investments are generally defined as securities.

One must be registered with the SEC when:

- ▶ **“Reg A” Offerings** – It has 500 or more investors and \$10 million or more in assets.
- ▶ It lists its securities on the stock markets (see the list in <http://www.sec.gov/investor/pubs/microcapstock.htm>)
- ▶ Its securities are quoted on the “Over-the-counter” Bulletin Board (OTCBB).
- ▶ Any company that offers or sells securities to the public.
- ▶ Exemptions for company not required to register:
 - Raising less than \$5 million in a 12-month period.
 - **“Reg D” Offerings** – Raising less than \$1 million dollars in a twelve-month period; Seeking to raise up to \$5 million, as long as the companies sell only to 35 or fewer individuals or any number of “accredited investors” who must meet high net worth or income standards; and, some larger private offerings of securities.

Avoiding “Land Mines”



One must be registered with the TX State Securities Board when:

- ▶ **Any securities that can be offered or sold in Texas.**
- ▶ **Exemptions for company not required to register:**
 - The total number of sales by any one owner or interests, whether whole, fractional, segregated or undivided in any single oil, gas or mineral lease, fee or title, or contract relating to, do not exceed thirty-five (35) within a period of twelve (12) consecutive months.
 - No use is made of advertisement or public solicitation.
- ▶ **One must be registered with FINRA when:**
 - Any securities firms doing business in the United States.

Avoiding “Land Mines”

Solicitors may try and avoid registrations by limiting the investment to **accredited investors. The SEC defines an accredited investor in Rule 501 of Regulation D as:**

- ▶ A bank, insurance company, registered investment company, business development company, or small business investment company
- ▶ An employee benefit plan within the meaning of the Employee Retirement Income Security Act
- ▶ A director , executive officer, or general partner of the company selling the securities.
- ▶ A business in which all the equity owners are accredited investors
- ▶ A natural person who has individual net worth that exceeds \$1 million at the time of purchase.

Avoiding “Land Mines”

- ▶ A business in which all the equity owners are accredited investors
- ▶ A natural person who has individual net worth that exceeds \$1 million at the time of purchase.
- ▶ A natural person with income exceeding \$200,000 in each of the two most recent years and a reasonable expectation of the same income level in the current year.
- ▶ A trust with assets in excess of \$5 million, and not formed to acquire the securities offered.

Avoiding “Land Mines”



August 4, 2017, the SEC filed charges against the “frack master’s” salesman. The SEC claims the salesman acted as “*the first line of the sales process*” calling on investors and handling customer calls and internet advertisement inquiries.

He allegedly led investors to believe he received no commission, yet received a percentage of every dollar invested, and was ultimately paid nearly \$1.6m.

Other salesmen, who pocketed nearly \$9m, were also charged.

Avoiding “Land Mines” Joint Ventures/Partnerships



FOCUS on the partnership agreements, which often times give the general partner the ability to:

- ▶ Have unlimited power and authority to take any action in connection with the management of the conduct of the business and the affairs of the partnership.
- ▶ Enter into agreements with other entities, affiliated or otherwise, for loans, purchases, or sales of partnership property.
- ▶ Finance the partnership's activities from partnership capital or by borrowing money from third parties, all on any terms and conditions the general partner deems appropriate.

Avoiding “Land Mines” Joint Ventures/Partnerships



All wells drilled on the Contract Area shall be drilled on a competitive contract basis at the usual rates prevailing in the area. If it so desires, Operator may employ its own tools and equipment in the drilling of the wells, but its charges shall not exceed the prevailing rates in the area. All work performed or materials supplied by affiliates or related parties of Operator shall be performed or supplied at competitive rates and in accordance with customs and standards prevailing in the industry.

Avoiding “Land Mines” Joint Ventures/Partnerships



- All wells drilled on the Contract Area shall be drilled on a competitive contract basis at the usual rates prevailing in the area.
 - Competitive with whom?
 - Rates for what?
- If it so desires
 - No oversight or approval needed for using its own tools, equipment, etc.
 - Overhead

Avoiding “Land Mines” Joint Ventures/Partnerships



6.7 Transactions with Affiliates. No Partner, Affiliate of a Partner or any owner of a Founder Limited Partner, may enter into (or materially amend the terms of) any transaction with, or provide services to, the Partnership, directly or directly [sic], unless the rate of compensation to be paid for any such transaction or services are not greater than the amount paid for similar services in arm's length transactions between unrelated parties (and the other terms thereof are equivalent to arm's length terms), and a Majority in Interest of the Partners have consented to such transaction or services.

Avoiding “Land Mines” Joint Ventures/Partnerships



Notwithstanding the prior sentence, the following services and transactions will not require consent of the Partners:

- Development and management services provided by or through the Project Manager;
- Payment of the Expense Advance to the Project Manager;
- Engineering and related services provided by or through COMPANY, a Texas limited liability company; and
- Any business established by the General Partner or an Affiliate of the General Partner or its owners, which is established for the primary purpose of purchasing equipment, supplies, furniture or inventory for the Project at rates lower than those generally available to the Partnership in the marketplace.

Avoiding “Land Mines” Joint Ventures/Partnerships



1. Conflicting terms – “no partner shall enter”, yet the very next paragraph provides an out:
 - “no Partner approval is required for the following:”
2. Ambiguities - Rates for related are commensurate with similar arms-length transactions. “Usual rates” “Standard terms”
 - As determined by whom?
 - How is this verified?
3. Generic terms
 - Development and “management services”
 - Engineering and “related services”
 - “Any business” purchasing.....
4. If all is fails “I can use my own”.
 - Who approves beforehand?

Know your role

Management

➤ DOJ

- The DOJ's focus is on "the individuals who play significant roles in setting a company on a course of criminal conduct."
- In the last two years, in the 12 months after this release, 45% of prosecutions under the Foreign Corrupt Practices Act (FCPA) were individuals.
- 55% of CAEs had been directed to omit or modify an important finding at least one; 17% three or more times.
- 49% were asked to not perform work in an area.
- 32% were asked to "target" individuals.

➤ Auditors

- It is not their primary to find fraud, yet it was recently suggested that there is a [99% chance of the "auditor" being sued](#) if actual fraud is not detected as part of an audit.

Know your role - FRAUD

- ▶ F – forgetting the present
- ▶ R – relying on others
- ▶ A – accepting, not verifying
- ▶ U – underestimate the effort
- ▶ D – determining the outcome before completion

Know your role

- ▶ **Know your partners.**
- ▶ **Know your agreements.**
- ▶ **Know your investors.**
- ▶ **Consistently enforce and honor “right to audit” clauses in contracts.**
- ▶ **Update background investigations regularly.**
- ▶ **Train and educate analysts and investigators.**
- ▶ **Avoid an over-reliance on others.**
- ▶ **Be an active participant, even in passive investments.**



Discussion and Additional Q&A



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